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PART I

The modern currency, exchange and credit structure. Explanation of the functions of a reserve bank.

All those banks, which are generally described as reserve banks, central banks or banks of issue are performing more or less the same functions. The duties of such banks are to direct the note issue and credit system of the country and to look after the rate of foreign exchange. In other words these banks are responsible for the smooth working of the internal and external means of payments. The internal means of payment are the notes and coins in circulation and the deposits with the banks, which are made payable by cheques. The external means of payment are the available foreign exchanges and gold in the country. An important part of the management of reserve banks (banks of issue, central banks) on the gold standard is furthermore to keep the price of gold stable.

It appears to be the simplest way through these complex problems to describe first what is the gold standard and the functions of reserve banks in connection with the gold standard. Secondly, the position of gold has to be analysed and the working of "inconvertible paper currencies."

There is only a slight difference between reserve banks on the one hand and central banks and banks of issue on the other hand. A reserve bank is such a central bank of issue, which, apart from all functions just described, has to keep, prescribed by law, a certain percentage of the deposits of the

various banks of the country as a banking reserve. The expression "central bank" is a general term. It means that such a bank is the central pivot of the country's manifold monetary matters. The term "bank of issue" lays the stress on the note issue. The name "reserve bank" points merely to the function of a guardian of banking reserves.* The proposed "Reserve Bank of India" will be, correctly speaking, an "Indian Central Reserve Bank of Issue". For the sake of brevity, we shall use the word "Reserve Bank" in this Note.

* There can be only one central bank in a country (Bank of England, Banque de France etc.) But there can be several banks of issue or reserve banks in one and the same country.

CHAPTER I

THE GOLD STANDARD AND ITS VARIETIES.

§ 1. *The primitive gold standard.*

To give a definition of the gold standard at the outset would not be practicable. To begin with, it is enough to state that a paper currency is linked to gold, if by one or another method the notes are exchangeable to a fixed weight of gold per unit of currency. In other words the price of gold is fixed under the gold standard system. The oldest assumed type of the gold standard was that simple monetary system when paper notes were still unknown, and gold coins formed the only sort of money in circulation. * Such a system may be described as the *primitive gold standard.*

§ 2. *The full gold standard.*

The development of banking and credit gave birth to the issue of paper currency notes. The system under which paper notes and gold coins are in circulation at one and the same time is the *full gold standard* described also as *gold specie standard* or *gold standard proper.* The notes are convertible into gold coins, *i.e.* the currency authority ** is compelled by law to convert all notes tendered into gold coins. The notes are partly backed by gold reserves and partly by security reserves. The proportion of these reserves varies in different countries. The security reserves consist of govern-

* Silver standard, silver currency and copper or nickel coins in circulation may be neglected for the present.

** The currency authority is in such countries where a reserve bank, a central bank, or a bank of issue is established that bank itself. In India, where no such bank exists at present a government dept., the Currency Dept. headed by the Controller of Currency discharges the functions of the currency authority.

ment securities and discounted commercial bills. Gold under the full gold standard can be freely imported and exported and the mints are open to the free coinage of gold.

§ 3. *The gold bullion standard.*

The gold bullion standard forms the next stage. Gold coins do not circulate but the currency authority is compelled by law to sell gold bars of a minimum weight and specified fineness. The notes are accordingly convertible into gold bullion and not into gold coins. The gold bullion standard was in force in Great Britain from 1925 up to 1931.

§ 4. *The gold exchange standard.*

The gold exchange standard is somewhat more complicated. Gold coins are not in circulation nor is the currency authority compelled to sell gold bars at a fixed price. The notes are convertible only into foreign gold exchange by the currency authority, *i.e.*, the currency authority has to sell the exchanges of such other countries which are on the gold standard, at such a price which enables the purchaser of foreign exchanges to import gold from foreign countries at a price equivalent to that at which the currency unit is linked to gold. The gold reserves under the gold exchange standard consist partly of gold bars and partly of foreign gold exchanges. The security reserves are the same as previously. As the notes are not convertible into gold, the gold reserves cannot leave the country.

The history of the Indian currency standard furnishes us with a good example of a gold exchange and also of a sterling exchange standard. During the decade preceding the War the Indian currency authority kept the rupee pegged to sterling at the rate of 1sh. 4d. by buying and selling sterling (council and reserve council bills). Since the first of April, 1927, (Act IV. of 1927) the Controller of Currency was compelled by law to sell and buy gold at the

price of Rs. 21–3–10 per tola of fine gold or, at his option, to sell sterling at a price which enables the purchaser to import gold from London to cost him not more than Rs. 21–3–10 per tola landed in India, having paid for packing, freight and insurance. On the 21st September, 1931, India abandoned the gold standard and the rupee is now pegged to sterling at the rate of 1sh. 6d.

CHAPTER II

BANK MONEY.

Modern financial conditions have, however, brought about a change, which has to be considered seriously.

Large payments now-a-days are affected solely by cheques, in places where banking facilities exist, and accordingly the role of notes and coins has greatly diminished.

At the present time the bulk of payments is effected by cheques, and the returns of clearing houses give an idea of the amounts involved. A cheque can be issued only against a deposit. Deposits on the other hand, as will be explained, are partly created by loans.

A glance at statistics will prove that the total of deposits in all countries with a developed banking system, greatly exceeds the actual currency in circulation. A few figures will make matters clear :—

End of 1931.	Total currency in circ :-	Deposits with banks :-	%
U. S. A. $	5647 millions	51681 millions	10%
U. K. £	364 „	2146 „	16%

The above table proves, that in countries where the cheque habit is strongly developed deposits are 6–10 times as much as the total currency in circulation

It is our task now to ascertain how, in *practice*, more deposits can come into being than actual currency in circulation. The first step is to point out that from the point of view of banking the actual currency in circulation may be divided into two compartments :—

(*a*) the currency notes or coins actually circulating with or hoarded by the public,

(*b*) the currency notes or coins deposited with the banks. The notes and coins deposited with the banks form the cash reserves of the banks. The proportion of the cash reserve to the deposits is the cash ratio usually expressed in percentage of the deposits. A cash ratio of 10% means accordingly that the cash reserves are 10% of the deposits.

To simplify matters it may be assumed that there is only one bank in a town, that the use of cheques is well advanced and that the cash ratio is 10%.

Now, if a client deposits Rs. 1,000/- with the bank in cash, the bank will have to retain Rs. 100/- in cash only and can grant loans upto Rs. 900/- to suitable debtors. The debtors to whom the loan of Rs. 900/- has been granted will most likely not take money in cash, but will effect payments by cheques. The recipients of these cheques will again deposit the cheques with the bank and thereby the loan of Rs. 900/- had the effect of creating new deposits to the extent of Rs. 900/-.

The position may be elucidated by the following figures at this stage :—

Deposits ...	Rs. 1,000	Cash ...	Rs. 1,000
	,, 900	Debtors ...	,, 900
Total ...	Rs. 1,900	Total ...	Rs. 1,900

Rs. 1,900 deposits on a 10% cash ratio basis require only Rs. 190 cash and accordingly a further loan of Rs. 1,000 minus Rs. 190 i.e. Rs. 810 can be granted. The position then will be as follows if we assume again that the cheques for Rs. 810 have returned to the bank as deposits :—

Deposits ...	Rs. 1,000	Cash ...	Rs. 1,000
	,, 900	Debtors ...	,, 900
	,, 810		,, 810
Total ...	Rs. 2,710	Total ...	Rs. 2,710

Rs. 2,710 deposits require only Rs. 271 as cash and now a loan of Rs. 729 can be granted. Assuming again that the proceeds of the new loan are again re-deposited with the bank the position will have changed as under—

Deposits ...	Rs. 1,000	Cash ...	Rs. 1,000
	„ 900	Debtors ...	„ 900
	„ 810		„ 810
	„ 729		„ 729
Total ...	Rs. 3,439	Total ...	Rs. 3,439

This procedure can be carried on up to the point when the total deposits reach ten times the amount of the cash reserve *i.e.*, in our example deposits of Rs. 10,000 versus a cash reserve of Rs. 1,000. The final position would be as under :—

Deposits ...	Rs. 10,000	Cash ...	Rs. 1,000
		Debtors ...	„ 9,000
Total ...	Rs. 10,000	Total ...	Rs. 10,000

The events just described can only take place if not one of the new debtors or creditors draws cash but all payments are effected solely by cheques. In case cash is drawn partly, the growth of deposits can expand only up to an amount ten times as high as the remaining cash.

Banks for various reasons, instead of granting loans up to the limit allowed by deposits, invest the sums available partly in buying gilt-edged securities. Such purchases do not alter the position for the simple reason as the bank will pay for the securities by cheques drawn upon self, which in turn might again be credited to the account of the seller of the security.

If, going a step further, we take the actual position into consideration, namely, that there are several banks operating in one and the same town, we will find that, adding

up the cash reserves, deposits and loans of all banks, the position will on the whole remain unaltered. The only difference will consist in the fact that the cash reserves, deposits and loans of individual banks will grow or decrease according to the behaviour of the public and the credit policy of individual banks. If one of the banks for instance, has a growing business more cheques will be deposited with that bank. Such a rising bank will be able to grant more loans and will draw away a portion of the cash reserves of other banks.

The management of the individual banks, on the other hand, may expand or contract credit, *i.e.*, increase or decrease its loans according to its business policy. An increase of loans however will find its limit in the average cash ratio, as by going beyond that ratio the bank will lose cash to other banks.

Payments effected by cheques represent deposits which may be described as *bank money* created by the above described procedure. In the modern monetary structure the role of bank money is far more important than that of cash money, *i.e.* currency notes and coins.

CHAPTER III

THE WORKING OF THE GOLD STANDARD.

The working of the gold standard proper and of the other varieties of the gold standard is fairly complicated. The most important functions of reserve banks being however connected with the working of the gold standard, it appears to be necessary to explain first the various factors of its working. The chief factors are :—

1. Contraction and expansion of currency.
2. Effects of contraction and expansion of currency on the price level.
3. The rate of foreign exchange.
4. The balance of foreign trade and payments.
5. The bank rate.

A short examination of these factors will prove to be useful :—

§ 1. *Contraction and expansion of currency.*

The expansion of currency *i. e.* an increase of the notes and coins in circulation can take place firstly against gold in case gold is tendered to the mint for coinage or to the currency authority to be exchanged for notes. Gold may flow into the country on account of a favourable balance of trade or payments, or may be released from hoards. On the other hand if gold is hoarded or leaves the country on account of an adverse foreign balance the currency is contracted against gold.

Secondly, the currency can be expanded by reserve banks against the purchase of government securities or by the discounting of bills, and contracted by sales of securities or by a restriction of discounting.

§ 2. *Effects of contraction and expansion of currency on the price level.*

Contraction and expansion of the currency have important effects on the level of prices. Expansion of currency increases the means of payment, a contraction has the opposite consequence. An increased circulation means more supply of money, a decrease creates demand for money. The value of money is just as dependent on supply and demand as that of any other commodity. The value of money is represented by the price level. If prices are high, the value of money is low, money has less purchasing power. Falling prices indicate a rise in the purchasing power of money. An expansion of monetary circulation, accordingly, will raise prices and a contraction will lower them, assuming that other relevant factors, such as movements in the normal demand for or supply of individual commodities remain unaltered. Apart from the quantity of money in circulation the purchasing power of money depends further on the velocity of the circulation and on the volume of business. If the circulation of money is fast, a smaller quantity in circulation will suffice. An increase in the volume of business, on the other hand, absorbs more money in circulation at the same price level. The fact that the purchasing power of money depends partly on changes in the quantity of money in circulation is, on broad lines what is known as the "quantity theory of money". An expansion of currency accordingly will result in a rise of prices and a contraction in lowering the price level.

§ 3. *The rate of foreign exchange.*

The parity of the currencies of two countries on the gold standard is equal to the proportion of the pure gold contents of their standard gold coins. The actual rate of exchange may fluctuate between the gold points only. Should for instance the rate of exchange rise on account of factors explained below, then there will be a certain point at which

it becomes cheaper for foreigners to send gold to the country than to buy exchange at a relatively high level in order to settle payments. The price of gold being fixed by law, the gold shipped from foreign countries can be sold to the currency authority and thus the necessary means of payment may be obtained. The cost of transport, insurance and interest of the gold imported will have to be added to, and in case of gold exports to be deducted from the par. The figures thus obtained will indicate the upper and lower gold points. The rate of foreign exchange of a currency linked to gold can only fluctuate between these gold points as any further rise or fall will be prevented by gold exports and imports respectively.

§ 4. *The balance of foreign trade and payments.*

The fluctuations of the rate of foreign exchange are influenced by the balance of foreign trade and payments. If a country exports more than it imports, the difference in value between exports and imports is the *favourable balance of trade.* Conversely if imports exceed exports the balance is an adverse one. Apart from the import and export of commodities there are payments to be effected with foreign countries for innumerable reasons, for instance, in connection with the settlement of foreign loans and services such as shipping freights, insurance and banking charges or commissions, also personal remittances, expenses of tourists etc., etc The balance of these payments can be an adverse or favourable one according to whether payments to foreign countries are higher than the receipts. In the long run the nature of these foreign balances will influence the trend of the rate of foreign exchange of a country. A favourable balance will raise and an adverse balance lower the rate of exchange. In case of a favourable balance, foreigners will have to effect payments to the country and there will be a growing demand for the exchange and the rate in consequence will rise. As discussed above, if the rate

touches the upper gold point, gold will flow into the country being a cheaper way of settling payments. An adverse balance will have the opposite effect. It will lower the rate of exchange and gold will leave the country if the lower gold point is reached. Speculation has also an important effect on the fluctuation of the rate of exchange.

Previously attention has been drawn to the fact that the expansion and contraction of the currency have a raising and lowering effect respectively on the price level. Now a further step has to be undertaken and the consequences of a higher and lower price level respectively on exports and imports will have to be examined. If prices are low in one country and high in another country, commodities will be exported from the first country to the second. High price levels encourage imports and check exports; low prices have just the opposite effect. Now we can link up these two observations and say that a contraction of currency will, by lowering prices tend to encourage exports and check imports, whereas an expansion of currency will by raising the price level tend to increase imports and lessen exports.

§ 5. *The bank rate.*

An important device of a developed banking and credit system is the bank rate, *i.e.*, the rate at which the reserve bank will discount bills and grant loans. A raising or a lowering of the bank rate will have important consequences on the economic life of the country. A rise in the bank rate will tend to discourage the expansion of credit, will check enterprise and finally by contracting currency and credit it will have a lowering effect on the price level. A lower price level encourages exports, checks imports and helps to improve the balance of trade.

A lowering of the bankrate on the other hand has the opposite effects:—Interest rates being lower more and more credit is absorbed, credit and currency expand, an expansion

of currency and credit will raise the price level. Higher prices encourage imports and check exports and the balance of trade will tend to be adverse.

§ 6. *The working of the primitive gold standard.*

All the above factors are elements of the functioning of the automatic working of the gold standard, and now an explanation of the automatic working of the gold standard may be essayed.

The working of the fully developed gold standard, often described also as "automatic working", is a fairly complicated process and therefore it appears to be advisable to describe first the working of the primitive gold standard.

As mentioned on page 3 the primitive gold standard is an assumed primary stage of currency evolution, without any banking and credit institutions, gold coins being the only currency in circulation.

If we assume that a country on the primitive gold standard has an unusually abundant harvest and as a consequence its exports during that year exceed its imports the favourable balance of trade will have to be paid by foreign countries in gold.

An inflow of foreign gold will expand the currency in circulation and such an expansion will raise the price level of the country. A higher price level on the other hand acts as a brake on exports and encourages imports and thus the favourable balance of trade will gradually become adverse. As a consequence of an adverse trade balance gold will leave the country, currency will be contracted and prices will fall. Falling prices again encourage exports and act as a brake on imports. In other words this automatic process consists in the fact that every extreme position of the balance of trade will be reversed through the price raising and lowering effects respectively of the inflow or outflow of gold.

§ 7. *The working of the fully developed gold standard.*

Now a description of the somewhat more complicated working of the fully developed gold standard may be attempted :—

Let it be assumed that the balance of trade and payments of a country are adverse during a certain period, and that as a consequence the rate of foreign exchange is falling. When the lower gold point is reached, gold will leave the country, thereby contracting currency and bank money. A contraction of currency, as explained previously, will lower the price level, increase exports, hamper imports and thus create a tendency of the balance of trade and payments to improve. The improved balance will naturally tend to raise the rate of foreign exchange. The fact that when the lower gold point is reached and when gold flows out of the country, the currency is contracted, automatically sets factors in motion which tend to better the economic conditions of the country. This so-called automatic working of the gold standard can be considerably increased by the management of the bankrate. For a suitable rise in the bankrate at times when gold is leaving the country, will help to contract credit and currency, thereby lowering the price level. Furthermore, the high rate of interest will stimulate the flow of foreign short term loans into the country. Foreign capital can enter the country either in the form of gold or by the purchase of the exchange, the rate of which will be raised by such purchases. As a result a tendency will be created by which the rate of exchange will be rising towards the upper gold point. When the upper gold point is reached gold will flow into the country, currency and credit will expand, prices will rise, exports will decrease and imports increase, the bankrate will be lowered and foreign short term loans will leave the country.

The automatic working of the gold standard acts as a sort of pendulum and tries to adjust extreme changes in the

economic conditions. These changes are usually described as the trade and credit cycles.

It deserves notice that during the last decade the management of the bank rate has been strengthened by "open market operations" too. In order, namely, to make the changes in the bank rate more effective, reserve banks sell and buy respectively government securities or bills in the open market and thereby directly contract and expand currency respectively.

The working of the gold standard, however, under a highly developed banking and credit system is not as automatic as under the primitive gold standard. That is to say the changes in the bank rate depend on the free will of the leaders of the reserve bank, and secondly the expansion and contraction of currency and credit under a highly developed system, depend also on the policy of the commereial banks and on the behaviour of the public. The reserve bank can expand the currency within the limits of the fiduciary issue, * the commercial banks can issue loans—*i.e.*, create bank money up to, say, 10 times the quantity of the cash reserves and lastly the public can hoard or invest the currency notes in circulation according to their free will. (This influence of the behaviour of the public is also felt under a primitive gold standard and accordingly even the working of the primitive gold standard is not absolutely automatic).

The policy of the banks and the behaviour of the public will influence the effects of the inflow of gold under a highly developed system and accordingly the "so-called" automatic working is not quite as automatic as under a primitive gold standard.

* The notes issued against securities are known as the *fiduciary issue.*

CHAPTER IV.

THE BREAKDOWN OF THE GOLD STANDARD. INCONVERTIBLE PAPER CURRENCIES.

§ 1. *Essential conditions of the working of the international gold standard.*

(*a*) *The international free flow of goods, services and capital.*

An attempt was made to describe the working of the gold standard in the previous chapters and it has been shown that the gold standard is an international standard, for its working depends on the free international exchange of *goods* (exports and imports, including gold), *services* (shipping, banking, insurance etc.) and *capital* (foreign loans). The mechanism described as the *automatic working of the gold standard* can only function, if the international exchange of goods, services and capital is more or less unhampered. The following points will explain that the gold standard can only function under what may be called *normal times*. The essential conditions are partly internal and partly external.

(*b*) *Normal withdrawal of deposits.*

Chapter 2 has pointed out the important role of *bank-money* in the modern monetary system. In all countries with an advanced banking system there is far more bankmoney (*i.e.* deposits liable to withdrawal by cheque) in circulation than currency notes and coins. It is evident, that if all depositors approach the banks for cash at one and the same time the modern banking system is bound to break down. Such *runs* on banks are caused by financial crisis, wars,

revolutions etc, and result in the temporary closing down of banks, in declaring moratoria and probably in the bankruptcy of weaker banks.

The breakdown of the monetary structure of the U. S. A. in February 1933 is a good example of the interconnectedness of such *runs* on banks and the suspension of the gold standard.

(*c*) *Normal demand for gold.*

The gold reserves under the gold standard system form a certain percentage of the currency notes in circulation. Similar to the runs of depositors on the banks, the noteholders, in times of crisis, will approach, panic-stricken, the currency authority and demand gold in exchange for their notes. Under such circumstances the gold standard has to be suspended, as is usually done at the outbreak of wars, revolutions or at times of violent financial crisis.

Summing up it may be said that the modern currency and banking system is based on the hope that all depositors will not ask the banks at one and the same time for cash and that the note-holders will not try to convert their notes for gold at one and the same time, *i.e.* that the demand for gold and notes will remain within reasonably normal limits.

(*d*) *No sudden withdrawal of foreign deposits.*

In countries the capital of which is an international money centre (London, New York, Paris etc.) the activities of foreign short term depositors are of great importance as became evident during the crisis of 1931, which ultimately led to the abandonment of the gold standard by Great Britain. It may for example happen—and this was the case of Great Britain in 1931—that the public remain calm and no runs on the banks and the currency authority take place, whereas foreign depositors ask for notes and finally for gold which they take out from the country. In case the gold reserves

of the country are gravely endangered, there remains no other alternative but to go off the gold standard.

Under *normal* circumstances it is assumed that foreign depositors will not withdraw suddenly their short term deposits and thus endanger the smooth working of the gold standard.

(*e*) *Debtor countries have to obtain foreign loans.*

Lastly the position of debtor countries having temporarily an adverse foreign balance has to be analysed. Every adverse foreign balance has to be paid for to foreign countries. The simplest way of payment is to export gold. Temporary insignificant adverse balances are *in fact* settled by gold exports. If on the other hand, the adverse balances are considerable and not merely of a temporary nature, foreign loans have to be contracted in order to tide over the lean years. Such was the case of most Central European and South American countries during the post-war period. These debtor countries were going on taking foreign loans up to the year 1931, when on account of the financial crisis no further loans were forthcoming. The stoppage of foreign loans finally led to moratoria, abandonment of the gold standard or in other cases to exchange restrictions.

It has to be stressed, however, that adverse foreign balances can only be temporarily remedied by gold exports or by contracting foreign loans. Sooner or later such a country has either to set its house in order or if such a reconstruction of the economic conditions is not possible, the gold standard has to be abandoned or exchange restrictions introduced and a moratorium as regards external payments declared.

§ 2. *The recent breakdown of the gold standard.*

The breakdown of the gold standard is greatly connected with all those events which are usually described as the *world economic and financial crisis.*

The world crisis has been again and again discussed in innumerable books, pamphlets, articles and lectures and therefore it seems to be unnecessary to analyse the causes and the course of the crisis again. The object of this paragraph is to elucidate the actual events connected with the recent breakdown of the gold standard in various countries. Paragraph 4 will depict the various currency standards and regulations now in force all over the world.

(a) The interruption of the international free flow of goods, services and capital.

In § 1 (a) of this chapter it has been explained that the international gold standard can only function if the international free flow of goods, services and capital is secured. Speaking in general it may be stated on broad lines that the international gold standard was bound to break down because as a consequence of the world crisis the free flow of goods, services and capital was obstructed in most countries of the world. This obstruction was caused mostly by tariff walls, import quotas, prohibition of foreign banking, shipping and insurance or state aid to indigenous industries, shipping companies etc. The gradual lack of confidence was also an important cause of the stoppage of the flow of capital from country to country. The crisis affected various countries in different ways as will be described below under (b), (c), (d) and (e).

(b) The breakdown of the gold standard in Great Britain.

The sudden outflow of foreign short term capital during the months of July and August, 1931, has led to the abandonment of the gold standard in Great Britain. Although a creditor country to the extent of several thousands of millions of sterling, Great Britain was compelled to abandon the gold standard on account of the outflow of the relatively trifle amount of foreign deposits worth about 200 million sterling,

as otherwise the entire gold reserves of the Bank of England (£ 135 millions at that time) would have been wiped out and the gold standard would have had to be abandoned a few weeks later in any case and the country would have been left without any gold reserves. The rate of foreign exchange fell by about 25 to 30% and later on was regulated with the help of the Exchange Equalisation Fund, as will be described in § 4.

(c) The breakdown of the gold standard in the U. S. A.

The breakdown of the gold standard in the U. S. A. was caused by internal events.* The long-protracted economic crisis and its chief consequence the fall in prices, has weakened the banking system. Whereas in England commercial banking is carried on by the "Big Five" Banks with the help of thousands of branches, in the U. S. A., there are only a few big banks in the large cities and banking all over the country is mainly carried on by thousands of small banks, which naturally have not the same resistance at times of crises as the British banking system. The low price level resulted in the fall of the value of the securities held by the banks against their loans and from the beginning of the year 1933 more and more banks failed. In consequence the confidence of the public weakened and gradually runs on banks for cash took place and more and more cash was hoarded by the population. At the same time the currency authorities were approached for gold by the public, partly for hoarding and partly for exporting purposes. Towards the end of February the position became desperate and on the 6th of March the banks were closed in order to prevent further runs and an embargo on gold was announced. Later on when the public gradually calmed down sound banks re-opened, but the gold standard had to be abandoned and the rate of foreign exchange depreciated.

* The causes in Great Britain were chiefly external.

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(d) The position of debtor countries.

The financial collapse of the debtor countries in Central Europe and in South America was connected with internal as well as external causes. Space precludes our entering into details and therefore the main points only will be indicated in general. No doubt in many of these debtor countries the banking system showed signs of weakness and runs were to be expected and in some towns actually took place. The weakness of the internal position led to moratoria, suspension of the convertibility of currency notes etc. The chief cause of the breakdown was however connected with the adverse foreign balances of these countries. The gold reserves as a consequence decreased considerably and the collapse was only delayed for years and years with the help of foreign loans which came forward in abundance from the creditor countries, such as Great Britain, U. S. A., France, Belgium, Switzerland and Holland.

In consequence of the world crisis the confidence towards these debtor countries gradually dwindled down during the year 1931. New foreign loans were not forthcoming and the instalments due and interest thereon were not paid by most of the debtor states. The gold standard had to be abandoned and moratoria as regards external payments had to be declared. Some of the debtor countries depreciated their exchanges whereas others had done their utmost to maintain the rate of foreign exchange unchanged with the help of exchange restrictions.

(e) The position of countries on the gold standard.

At present only 6 countries are on the effective gold standard (France, Belgium, Holland, Switzerland, Italy and Poland) and although these countries have solemnly declared at the World Economic Conference that they will do all in their power to maintain the gold standard they are experiencing

the most unpleasant competition of countries with depreciated exchanges as regards foreign trade. It is questionable whether under such circumstances these countries will find it possible in the long run to maintain the gold standard at the present high rate of exchange at a great sacrifice and to the detriment of their trade, industry and agriculture.

§ 3. *Is a return to the gold standard possible ?*

The breakdown of the gold standard has been explained and in this connection the question as to whether a return to the gold standard is possible and practicable deserves serious attention. At present far the greatest part of the world is off gold. The various paper currency systems actually working will be explained in § 4, and at the same time an attempt will be made to forecast whether one or another form of managed paper currencies could likely be the currency standard of the future.

The Gold Delegation of the League of Nations have expressed in their Report (June 1932) their views on this subject by pointing out that :—

> —"at the present stage of world economic development, the gold standard remains the best available monetary mechanism."

Furthermore, the Delegation maintain, that if certain guiding principles will be observed in future, the gold standard will be capable of functioning satisfactorily and will be as stable as other proposed managed paper currency standards.

The Delegation emphasise, however, that the restoration of a reasonable degree of freedom in the international movement of goods, services and capital is a pre-essential condition of the re-establishment of the gold standard. Furthermore, a satisfactory settlement of war debts and reparations is necessary. The guiding principles mentioned above are *firstly*, that the inflow and outflow of gold should not be prevented

to exercise their influence on the price level as explained in connection with the automatic working of the gold standard. Only in case the movements of gold can freely raise or lower the price level can the automatic working of the gold standard be restored. *

Secondly, the economic use of gold is also of great importance. Gold coins should not circulate and the gold reserve ratio *i. e.* the percentage of the minimum gold cover should be reduced.

Thirdly, the Delegation believe, that with the help of a suitable policy directed to this purpose, and with necessary open market operations, coupled with a successful international co-operation of central banks, the gold standard could be so managed, that a reasonable degree of price stability could be achieved. The severe fall in prices during the last few years has been one of the strongest arguments of the opposers of the gold standard who claim, that managed paper currencies would be far more useful in order to achieve an ideal price stability. The details of this important question will be discussed below.

The present problem consists of two main questions :—

(1) Is a return to the gold standard possible, and

(2) if a return to the gold standard is not possible, are there such managed paper currency standards which could work satisfactorily in the long run ?

Question 2 can only be answered after an analysis of paper currency standards has been undertaken in § 4. An attempt to reply to question 1 is our immediate task :—

Considering all essential conditions of the working of the gold standard, it appears that the restoration of the inter-

* The inflow of gold is prevented to exercise its influence on the price level *i. e.* to create a rise in prices by what is usually described as "sterilising gold". This "sterilisation" consists in the fact, that when gold enters the country and is finally sold to the reserve bank, the management of the bank counteracts the expansion of currency thus taking place by selling some of its security reserves. The expansion is counteracted by these sales which again contract currency to the previous level. Finally no change has taken place in the volume of currency, but security reserves have been replaced by gold reserves.

national free flow of goods, services and capital is in fact the *sine qua non* on which the possibility of a re-introduction of the gold standard depends. In other words, is there a likelihood of a return of free trade ?

It appears, accordingly, that the underlying problem which has to be analysed is nothing less than to try and pass judgment on the controversy whether free trade can be restored or not.

It is a well-known fact that there are two schools of thought to-day in this respect.

The *conservative school of thought* advocate that a return to free trade is the essential condition of putting an end to the world crisis and is the only method to restore normal and prosperous conditions in the world. According to this school of thought tariff-walls will have to be lowered, international lending will have to be resumed and the gold standard restored as soon as possible.

The *reformatory school* headed by President Roosevelt does not believe in the possibility of the restoration of free trade and the gold standard for a long time to come. The motto of this school has been clearly formulated by the President.

> "That the internal well-being of a country is far more important than the rate of its foreign exchange."

The reformatory school emphasises that during the last few decades new industries have been established all over the world, that the industralisation of hitherto agricultural countries is going fast ahead and as a consequence every country is bound to protect its industries by tariff walls. If the free flow of trade cannot be restored, there is practically little or no likelihood of the restoration of the gold standard. Furthermore, they recommend to counteract the disadvantages caused by the present low price level, with a suitable expansion of currency in order to raise prices to

such a higher level as might readjust again the position of creditors and debtors at present out of gear.

This school is in favour of the principle of planned economy. Mr. J. M. Keynes, Sir Arthur Salter and Sir Basil Blackett are the advocates in Great-Britain of these ideas.

It is not the object of this book to forecast the future and accordingly it is not attempted to deliver judgment on the suggestions of these two schools of thought. It deserves, however, notice that the suggestions of the conservative school are more or less the expression of a hope only. This school feel that it would be better to return to free trade and to the gold standard because the world was, in bygone days, prosperous under those institutions and a return, they anticipate, might restore this prosperity. It has to be mentioned, however, that the conservative school have hitherto never attempted to state what motives would possibly induce various countries to lower their tariff walls and thus endanger their national industries.

One is rather inclined to feel that the reformatory school is not far from the truth in believing that there is little chance left in this world of growing industrialism of a lowering of tariff walls and that accordingly there is a reason to believe, that managed paper currencies will hold the field in the near future.

The importance of a thorough analysis of paper standards is therefore most essential and will now be attempted.

§ 4. *Inconvertible paper currencies and their working.*

(a) *How can an inconvertible paper currency function as money.*

Currencies not convertible into gold or silver are paper currencies. Such inconvertible paper currencies have gene-

rally been regarded up to now as the outcome of an emergency situation, of abnormal conditions caused by wars, revolutions, financial crises. In the past theoretical economists only have discussed the possibility that such an inconvertible paper currency should be the permanent standard of the future. To-day the problem is a far more practical one. Grave doubts have been expressed by some practical men whether a return to the gold standard is possible and even if possible, whether it is desirable.

The first point to be explained is, what gives value *i. e.* purchasing power, to an inconvertible paper currency ?

The reply is simple. The purchasing power of a paper currency whether on or off the gold standard depends on the quantity of notes and bank money in circulation. * An expansion of currency, *i. e.* if more notes and bank money come into circulation, will raise the price level and as a consequence the purchasing power of the notes will decrease ; on the other hand a contraction of currency will lower prices and thus raise the purchasing power of money.

The fact that an inconvertible paper currency can well function as money, has two foundations. *Firstly* the power of the State by its declaration that inconvertible paper currency has to be accepted as unlimited legal tender for the discharge of debts and *secondly* for the simple reason that its value is regulated by the quantity in circulation. The quantity in circulation, on the other hand, depends greatly on the currency authority.

At present the greatest part of the world is actually using inconvertible paper currencies. To the layman the actual currency conditions of the world may appear as chaotic and therefore it will be attempted in this paragraph to throw light on the subject and point out the various systems of

* The influence of the volume of business and the velocity of circulation may be omitted here so as not to complicate matters.

inconvertible paper currencies in use at present in different countries.

(*b*) *The world currency position in 1933.* (*See table*)

As mentioned above some five countries are still on the gold standard. Apart from China, the only country on the silver standard, all other countries have inconvertible paper currencies to-day.

Inconvertible paper currencies are either *nonregulated inconvertible paper currencies* with a freely fluctuating rate of foreign exchange or they are regulated by some or the other method. These regulations are carried out either with the help of exchange restrictions or with the help of open market operations. These varieties are described below.

(*c*) *Non-regulated inconvertible paper currencies.*

Firstly the position of such countries has to be explained which have abandoned the gold standard, depreciated the rate of their foreign exchange and have neither introduced exchange restrictions nor succeeded in managing their currency system so as to achieve some sort of stability. Such currencies may rightly be described as non-regulated inconvertible paper-currencies, with a freely fluctuating rate of foreign exchange. The classical examples of such currencies, as mentioned above, were to be found in Central Europe during the War and post-War inflation. The internal and external position under such circumstances depends on the expansion of currency and on the foreign balances of the country. If the currency is greatly expanded prices will rise, the purchasing power of the country's monetary unit fall. If the fall in the rate of foreign exchange is faster than the rise in prices, exports will be facilitated. If on the other hand the rise in price of commodities is faster than the drop of the foreign exchange rate then exports will be hampered. The fall in the exchange rate under such circumstances is not quite so clearly in

proportion with the balance of trade and payments as under the gold standard. The flight from such exchanges is also a marked factor, for all capitalists will try to buy foreign exchanges in order to transfer their money to foreign countries with a more stable exchange. Internal and external speculation will also go far in depreciating the exchange of such a country. * At present only a few small countries belong to this group.

(d) Exchange restrictions.

Exchange restrictions are introduced when a country is in a weak financial position, and the government decides to keep up the rate of foreign exchange on the gold parity at any cost. The characteristic feature of this measure is to maintain the gold parity, although the gold standard is not effective and the currency is in fact an inconvertible paper currency. To achieve this artificial stability of exchange, the free market of foreign exchanges is prohibited by law or by ordinance and a central office handling the entire foreign exchange business of the country is established, usually within the frame work of the central bank. All exporters and all other holders of foreign exchanges are obliged to sell their foreign exchanges to the central office. The foreign exchanges thus obtained are distributed amongst the importers of such foreign goods the imports of which are found to be necessary by the state authorities. Exchange restrictions result in a strong decrease of imports for the sake of improving the balance of trade and are sometimes connected with import embargos or import quotas in respect of the imports of certain wholly or partly undesirable foreign commodities.

It has to be noted, however, that practically in every country with exchange restrictions there is a secret market described by the "*Economist*" as "black" market where foreign exchanges are bought and sold at prices higher than the

* Space forbids to demonstrate the importance of the purchasing power parity.

official prices quoted by the central office. These "black" markets are criminally prosecuted. It deserves notice that even official reports of Financial Commissioners of the League of Nations refer to the price level of these "black" markets. The dealings in gold coins and bullion, on the other hand, are free in most of those countries and as a conssequence the peculiar, one may also say "absurd" situation has arisen, that the price of gold in the open market is about 20 to 30% higher than the rate at which the currency unit was linked to gold and notwithstanding this fact these countries, specially in Central Europe, claim still to be on the gold standard !

Foreign trade and also internal business are greatly hampered by restrictions, which can be looked upon as temporary measures only and serve to tide over a period of exceptional difficulty. During the war, and at the time of depreciated exchanges, restrictions proved to be quite useful. The present situation, however, with dozens of countries having introduced restrictions is not maintainable over a protracted period, as every business enterprise is bound thereby to be strangled to death.

These, chiefly Central European countries will gradually have to face facts and to understand that in the long run a parity which is not in accordance with the economic conditions of the country cannot be maintained by artificial means and that final decisions will have to be made in one or the other direction.

There are also countries which had to abandon the gold standard on account of their financial weakness and to depreciate the rate of their foreign exchange. Later on, however, some of these countries have decided to stabilise their exchange at a lower ratio with the help of the exchange restrictions described above. Quite a number of countries were successful in this respect. The remarks made above about decisions about the future hold good also in respect of these countries.

(e) *Managed paper currencies. The sterling group. Exchange Equalisation Fund.*

The sterling, since the abandonment of the gold standard in September 1931, and also the rupee, linked to sterling, are the outstanding examples of managed paper currencies. The British currency authority, *i. e.* the joint co-operation of the Bank of England and the Treasury, has so managed the paper sterling since 1931, chiefly with the help of open market operations, contracting and expanding currency according to the desired goal, that the purchasing power of the paper sterling remained practically unaltered.

For this purpose an Exchange Equalisation Fund has been instituted with a capital of £150,000,000 raised later to £300,000,000 in order to maintain the foreign rate of exchange of the sterling steady or to direct it accordingly to economic necessities and to avoid violent fluctuations caused by speculators. This Fund buys foreign exchanges or gold if a rise in the rate of foreign exchange should be avoided and sells foreign exchanges or gold if a drop in the rate is to be eliminated. The rupee being linked to sterling follows the movements of sterling.

The rupee and other currencies of the sterling group are linked to sterling and managed with the help of sterling reserves. The Indian currency authority can, by selling and buying sterling respectively, keep the rupee fairly stable round about 1sh. 6d. (1sh. 5¾d.—1sh. 6-3/16).

(f) The stability of prices.

The stability of prices is looked upon as one of the most essential features of monetary policy to-day. It has been gradually recognised that falling or rising prices will hit either the productive classes or those with a fixed income. Great changes in the price level, as experienced in the last few years bring a very undesirable instability into the economic

life and excessive booms followed by severe depressions are the consequence. The fluctuations of the price level are greatly dependent on the contraction and expansion of the currency and as these changes can be effected with the help of the bankrate and open market operations, there seems to be no difficulty in keeping the price level of a country fairly stable, say within a limit of 10%. The chief problem however consists in the difficulty of maintaining the stability of the rate of foreign exchanges and that of the price level at the same time. Such a double stability can be achieved within a group of countries only that agree to link their currencies to the currency of one of these countries after having stabilised their price level at such a figure which they desire to maintain. With the help of a parallel monetary policy it seems to be possible to maintain the stability of exchanges and price levels in case the free flow of goods, services and capital is unhampered for without these preliminaries no stability of exchange can be maintained whether on the gold standard or in case of managed paper currencies.

(*g*) *Conclusions.*

A brief analysis of the various currency systems prevalent in the world at present has been attempted. The results are demonstrated on the table in front.

A reply has to be given now to the second question mentioned on page 24 :—

If a return to the gold standard is not possible, is there such an inconvertible managed paper currency standard which could work satisfactorily in the long run?

The experience of the last few years proves that the paper sterling, managed with the help of open market operations for internal purposes, and with the help of the Exchange Equalisation Fund for external purposes, has more

or less proved to be a standard not far from the ideal paper standard. The price level, as stated above, remained remarkably stable in the sterling countries since 1931. As a consequence of this stability it has been proposed that countries off gold should link their currency to sterling and form a sterling group, the *Sterlingaria* suggested by Sir Basil Blackett, and carry out a parallel monetary policy with the co-operation of their central banks. The difficulties of this otherwise reasonable proposition, which would guarantee stability of exchange and at the same time stability of prices, are twofold :—

The *first* difficulty which may be felt, consists in the fact that it is most unlikely that countries with a different economic structure could in the long run agree to one and the same monetary policy and that such a uniform monetary policy could be beneficial alike to all countries constituting the group.

The *second* difficulty is of a political nature, as it gives a political predominance, even if seemingly only, to the leading country. In these days of growing nationalism and independence, the drawback of this factor cannot be neglected.

There is no doubt left that from this point of view the international gold standard had an ideal basis in the form of gold, *i.e.* a completely neutral substance, to which all countries on gold were linked.

It remains now only to cast a glance at the near future.

There is little doubt left that the present strong trend towards building up the self-supporting position of practically all nations is going to continue for a long time to come. With such a tendency as leading motive, tariff-walls will rather be heightened, than lowered and accordingly there is little chance of an early restoration of the international gold standard. The trend of evolution seems to be in every

respect in the direction of a gradual extension of more or less self supporting groups, which, if they can really co-operate for their mutual interest, adopting the principle of give and take, may even eliminate the above mentioned two difficulties. If the co-operation and the mutual adjustment by the way of compromise is really sincere, the fear of a political supremacy of the leader of the group may fade away and the partly divergent interests of the various members of the group may be reasonably co-ordinated.

CHAPTER V.

THE FUNCTIONS & MANAGEMENT OF RESERVE BANKS.

§ 1. *The interconnectedness of the main functions.*

The main functions of reserve banks are :—

(*i*) the note issue and the regulation of credit,
(*ii*) the management of the rate of foreign exchange,
(*iii*) to keep the reserves in accordance with the prescriptions of law,
(*iv*) to act as bankers to the government,
(*v*) to be a "bankers bank", and
(*vi*) to satisfy indirectly the legitimate credit requirements of industry, trade and agriculture.

It may be assumed that the explanation of the automatic working of the gold standard has made the interconnectedness of the main functions of a reserve bank sufficiently clear and it may be added that the position off gold is not altogether different.

It is probably not necessary to go into details in order to explain further this interconnectedness. A simple example will elucidate the position :—

An expansion of currency, whatever its underlying motive may be, will react on prices, on foreign trade, on the composition of the reserves, on the rate of foreign exchange, on the interest rate, on the demand for new loans, and will stimulate production. A contraction has naturally the opposite effects. Whatever the underlying motives of an expansion or contraction may be, the above mentioned effects will always take place, more or less. This rigid interconnectedness makes the management of a reserve bank extremely

complicated, for no economic problem to be solved can be treated on its merits solely, as the repercussions of every change on all domains of the economic life have to be judiciously considered prior to taking any action.

It is perfectly correct to emphasize that the management of a reserve bank is an art and not a science. And if this was true during the days of the gold standard, although certain general rules and principles could have been observed at that time, it is far more valid to-day when the governors of reserve banks have to manage inconvertible paper currencies and when the changes in the price level are greater during the period of one year, than in prewar days during the lifetime of a generation.

§ 2. *The note issue and the regulation of credit.*

The most visible function of a reserve bank is no doubt the note issue. Reserve banks issue uotes against the purchase of gold, foreign exchange, government securities or commercial bills.* These assets purchased against the issue of notes form the reserves. The principles as regards the composition of the reserves will be dealt with below. The withdrawal of notes—contraction of currency—takes place against the sale of the above mentioned assets, and through the repayment of government securities or commercial bills on the due dates.

Note issue against coins is only a conversion of one instrument of payment against another and thus does not influence the volume of currency in circulation.

(*a*) *Expansion and contraction caused by actions of the public.*

Contraction or expansion of currency is partly caused by actions of the public and partly by planned operations of reserve banks in order to carry out a certain policy. If the public sell gold or foreign exchanges to the reserve bank,

* Silver may be neglected in this connection.

notes *have* to be issued and the currency expands thereby whether in accordance with the policy of the reserve bank or not. The public can also expand the volume of currency in circulation by releasing hoarded notes and coins. Reserve banks cannot be forced to purchase or discount bills *i.e.* to expand credit against their decided policy. If, on the other hand, the public buy gold or foreign exchanges from the reserve bank, repay bills of exchange, or hoard notes and coins currency is contracted thereby.

The experience of the last few years has brought monetary actions of the public strongly into the limelight. The hoarding and release of gold and notes by the public played a prominent part in the monetary history of India and U. S. A. in the last few years.

It deserves notice that monetary theory is decidedly inclined to neglect the importance of the role of the behaviour of the public and its influence on monetary matters. * It is hoped that theoretical economists will under the pressure of the latest events pay greater attention in future to this essential point. Unfortunately space forbids to pursue this interesting problem from the theoretical point of view. A practical aspect of this phenomenon will be discussed under (*b*).

(*b*). *Expansion and contraction by decided actions of reserve banks.*

The above described changes in the note issue caused by actions of the public may however be directly opposed to the policy pursued at that time by the reserve bank and it will have to be demonstrated now by what devices can the management of a reserve bank counteract the effects of these haphazardous actions of the public.

It may happen, for instance, that the public by hoarding notes or coins, by the purchase of gold from the reserve bank

* Paras 11, 12, 13 & 14 of the Report (1932) of the Gold Delegation of the League of Nations have very precisely indicated the role of the public.

for hoarding or exporting and by the purchase of foreign exchanges for transferring money to foreign conntries contract currency gradually, against the policy of the reserve bank. What devices are at the disposal of the reserve bank under such circumstances to counteract the contraction caused by the behaviour of the public ? The reserve bank can expand the currency under all circumstances only by the issue of notes against the purchase of goverment securities. It is most unlikely that the currency could be expanded by the purchase of gold for the simple reason that under such circumstances gold will not be forthcoming at the fixed price on the gold standard. It may also happen that for reasons peculiar to some countries no bills for purchase or rediscounting will be available *. It is evident therefore that the only device to expand currency will be a purchase of government securities in the open market. It may be pointed out however that even a steady expansion of currency resulting from the purchase of government securities can be counteracted by the public by an increased hoarding of notes. This device cannot under all circumstances be successful as the limit of the fiduciary issue (see below) may be reached, and also the available banking resources of the reserve bank may be exhausted. If the public goes on hoarding and thereby contracting currency, the reserve bank may completely fail to become the master of the situation. Such a situation ends with a financial crisis as happened in so many countries during the last few years.

As regards contraction there is a greater number of devices at the disposal of reserve banks and these devices will under all circumstances be effective. The volume of currency in circulation can be contracted by the sale of any of the assets contained in the reserves i.e. gold, government securities or bills. The sale of gold might perhaps not be possible on the

* Bills may not be availabie for instance on account of the predomlnance of cash credits. See the case of India and South Africa.

gold standard as the price can not be lowered. Government securities can however be sold at lower prices and bills at a lower rate of interest. Such transactions cannot fail in the long run, for the actions of the public expanding currency are absolutely limited by the volume of their hoards. These activities of reserve banks, usually described as open market operations, are carried out for various reasons in order to make the policy of the reserve bank effective. The aim of such a policy may be to regulate the rate of foreign exchange, to supply or contract credit and currency according to the needs of the country and sometimes also to stimulate business or on the contrary to check excessive speculation.

At present the returns of reserve banks do not show the actions of the public separately and therefore it is not possible to discriminate whether changes in the volume of currency are caused by the public or are the consequences of decided actions of the reserve banks. It may be considered whether such a division would not be useful.

3. *The composition of the reserves.*

The law of various countries prescribes different rules as regards the currency reserves. These rules have to be outlined now, so as to be in a position to demonstrate the functions of reserve banks in this respect. There are various reserve-systems but they may conveniently be divided into two main groups, *i.e.* the fixed fiduciary system and the proportionate fiduciary system.

(*a*). *The fixed fiduciary system.*

The system, under which the fiduciary issue of notes against securities is limited by law to a fixed amount is the British system. All other countries (except Japan) have adopted the proportionate fiduciary system of keeping a fixed proportion between security reserves and metallic reserves.

The fiduciary issue was fixed in Great Britain at £14 millions in pre-war days and was gradually raised to £275 millions in 1931. Every expansion of the fiduciary issue has to be authorised by the Treasury. Apart from the fiduciary issue all other notes have to be fully covered by gold, *i.e.* can only be issued against the purchase of gold.

(b) The proportionate system.

Apart from Great Britain and Japan all other countries have adopted the proportionate fiduciarv system whereby the issue of notes against securities can take place in a fixed proportion. For example, if the proportion of the gold cover is to be 40% of the entire note issue, 60 units of new currency can be issued on the strength of securities against every 40 unit of currency issued against gold. In other words if the gold or foreign exchange holdings of a reserve bank increase by 40 units the bank is authorised to buy government securities or bills for 60 units, thereby issuing another 60 units of fresh currency.

A comparison between the two systems reveals that the proportionate fiduciary system is the more elastic. Every purchase of gold or foreign exchange may be accompanied by a further expansion against securities. A decrease of the gold or foreign exchange reserves caused by the sale of gold or foreign exchange will necessarily have the consequence of a further contraction of the currency in order to restore the legal proportion. According to the rules of this system contraction and expansion will be more vehement and accordingly every loss of or increase in the gold or foreign exchange reserves will have a stronger effect than under the fixed fiduciary issue. If under the fixed fiduciary issue the fiduciary limit is reached, currency can only be expanded against the purchase of gold or foreign exchange. The rigidity of the fixed fiduciary issue is counterbalanced in Great Britain by the great elasticity of bankmoney. The use of cheques is much developed in Great

Britain and the cash ratio of the banks fairly low and accordingly the elastic expansion or contraction of bankmoney is equal to the advantages of the more elastic proportionate fiduciary issue of other countries.

§ 4. *The management of the rate of foreign exchange.*

If the reserve bank contracts or expands currency or raises or lowers the bankrate, these actions have only an indirect effect on the rate of foreign exchange (See pages 15 and 16). A sale of foreign exchanges or gold, on the other hand, have a direct effect on the rate of exchange just as open market operations. Such sales or purchases of foreign exchanges are carried out in order to make the policy of the reserve bank directly effective.

§ 5. *The bank rate. Direct and indirect devices.*

It deserves notice that reserve banks, according to the above explanations, have direct and indirect devices with which they carry out their policy. An indirect weapon is a change in the bankrate both for influencing the credit as well as the exchange position. Expansion or contraction of currency are indirect devices as regards changes in the rate of foreign exchange, whereas they are direct devices as regards the credit position. Sale or purchase of foreign exchanges are direct devices to influence the rate of foreign exchange. It is a matter of skill how to operate with these devices and decisions can only be made according to the actual position. The management of a reserve bank has to develop a sixth sense with which to be able to forecast the likely effects of its operations on the economic life of the country.

§ 6. *Reserve banks as bankers to government.*

Reserve banks being the central pivot of the countrys' banking and monetary structure, usually act as bankers to

the Government. The monetary transactions of Government are by far the greatest in every country and their importance and influence on the money market makes it necessary to concentrate these operations in the hands of reserve banks. The Government is the largest depositor in every country and at the same time the largest debtor both on long and short terms. Its foreign exchange operations if not concentrated in one hand could cause considerable disequilibrium of the ratio.

It could be argued that this huge business which is connected with considerable profit for the banker even at the lowest scale of commission, ought to be distributed so as to help all sound banks of the country. A glance at the practical consequences of such a distribution will reveal the impracticability and dangers of this proposition. The banking transactions which take place on account of Government, would, without fail, throw out of gear the monetary structure of the country, if not wisely conducted by one and the same authority, which could be scarcely any other than the reserve bank.

The volume of credit and exchange transactions of Governments make it imperative that they should be guided by that institution which is in fact the central pivot of banking. The interconnectedness of the main functions of reserve banks has been emphasized and it would not be difficult to demonstrate that transactions of the size of those done on behalf of Governments, would counteract all calculations of a reserve bank, if distributed amongst the commercial banks and carried out unsystematically. For this reason, practically all over the would, reserve banks act as bankers to government.

§ 7. *The reserve bank as bankers' bank.*

That a reserve bank has to act as a "bankers' bank" is widely known, but its implications are rarely understood,

the more as these functions vary in different countries. In countries where the re-discounting system is in full swing, the reserve bank acts in fact as a banker to its member banks, being the chief direct source of credit. Also in case a reserve bank grants credit on various specified securities, to the member banks. In countries where banks are compelled by law to keep a certain percentage of their deposits with the reserve bank this duty is also a connecting link.

The problem whether a reserve bank should be authorised to deal directly with the clients and thus compete with the commercial banks is of great importance. Based on historical developments some of the older reserve banks of the world may transact all banking business with clients directly. It should not, however, be forgotten that in countries with a long established reserve bank the commercial banks are as a rule so strongly founded that competition of the reserve bank, though probably unpleasant, cannot do too much harm. As a matter of principle, and chiefly in countries with an undeveloped banking system one is rather inclined to feel that a reserve bank should not be allowed to deal directly with clients, for its huge resources could render its competition most unfair. The provision, that in order to carry out open market operations, certain direct business can be transacted by reserve banks, is a sound exception and its omission would debar the reserve bank from its most important weapon. The transactions carried out in connection with open market operations are in fact not such a type of business as comes under the category of regular clients business.

The functions of reserve banks as bankers' banks will be elucidated in further details later on and also the role which reserve banks play in connection with the credit needs of industry, agriculture and trade.

PART II.

The Reserve Bank of India Bill, 1933.

CHAPTER I.

INTRODUCTION.

§ 1. *The Reserve Bank and the Constitutional Reforms.*

According to para 32 of the Introduction of the White Paper, 1933 :—

> "The proposals relating to responsibility for the Finance of the Federation are based on the assumption that before the first Federal Ministry comes into being a Reserve Bank free from political influence will have been set up by Indian legislation and be already successfully operating. The Bank would be entrusted with the management of currency and exchange."

In other words the introduction of responsibility at the Centre as regards Finance is based on the condition that prior to the reforms at the Centre a Reserve Bank will be established in India free from political influence and that this Bank will work successfully.

The practical meaning of "free from political influence" will be interpreted in Part III from various angles of vision in connection with the analysis of the problem whether the Reserve Bank should be a State Bank or a Shareholders Bank.

To establish a Reserve Bank "free from political influence" in the right sense of the word is a relatively easy

task* as compared with the second condition *i.e.*, that the Reserve Bank will have to operate "successfully" before responsibility at the Centre in financial matters can be achieved.

It is the chief object of this Book to try to visualise how a Reserve Bank in India could work successfully. No doubt, the word "success" is a rather relative expression and therefore it will have to be elucidated from various points of view.

Whether the Bank is successful or not will be the main issue before Federation and Responsibility at the Centre are to be inaugurated and accordingly it will be of decisive importance to outline beforehand, what state of affairs should be considered a success.

Another aspect of the problem has also to be considered in this connection. A Reserve Bank Act is only a frame within the limitations of which the Reserve Bank can actually function. An unsuitable Act can naturally debar the Reserve Bank right from the outset to work successfully. A Reserve Bank constituted on the basis of a well framed Act can, however, become a complete failure, if badly governed. That the future of the Reserve Bank will depend essentially on the management is generally accepted.

The chief points to be discussed accordingly are :—

(*a*) Whether the Reserve Bank of India Bill, 1933 as introduced in the Assembly is suitable in all details to the needs of this country, and whether it will not hamper the management in achieving success. This aspect is the main point of view in the light of which the Bill will have to be examined throughout this Book.

(*b*) What are the expected difficulties of the management and what ways and means may be devised

*It is a matter of the constitution of the Bank only.

to overcome such difficulties. In other words how will the future Reserve Bank work.

A perusal of the debates and literature on the subject reveals the fact, that up to now very little has been said and written about the working possibilities of the future Reserve Bank. The discussions of the Members of the Central Banking Enquiry Committee with Dr Trip, Governor of the Netherlands Bank (of issue) form the only attempt which has been undertaken to face the problems which the management of the Bank will most likely encounter in course of the first few years.*

The third and the rather intricate object of these pages will be to visualise the working of the Bank in its interconnectedness with the economic structure of the country.

The importance of a correct framing of the Reserve Bank Bill and of the efficiency and skill of the management should in no way be underestimated.

The inauguration of the proposed Constitutional Reforms will depend entirely on the success of the Bank according to the conditions laid down in the White Paper.**

Another point of view is not less important. The establishment of a Reserve Bank in India will be a new financial and economic experiment, and it has to be emphasised that such an experiment may turn out to be a success but can also be a complete failure. A failure of the Reserve Bank, apart from the contitutional consequences would react very prejudicially on the entire economic structure of the country which could hardly be remedied during the lifetime of a generation. It should not be forgotten that nearly all Central Banks operating in other countries are the outcome of a gradual evolution, whereas,

*See Indian Central Banking Enquiry Committee, 1933 Volume IV, Discussions with Foreign Experts, page 358-595 and 743-795.

**It will be assumed throughout these pages that the Reformed Constitution will be more or less on the lines of the White Paper.

the new Reserve Bank of India will be an institution suddenly superimposed on top of what may rightly be described as a non-organic and not well founded economic structure. The task of the first set of Governors will be much more complicated and far more responsible than that of any of the Governors of foreign Central Banks. The failure of the South African Reserve Bank should serve as a warning.

§ 2. *Can the provisions of the bill satisfy the needs of a national Indian economic policy?*

In these days of growing economic nationalism all over the world it is natural that the above question will be asked.

It has been stated in para 1 that a Reserve Bank Act is only a frame within which the management can operate and accordingly a Reserve Bank Act would scarcely lay down the foundations of a national economic policy for the simple reason that no Act can lay down any policy at all. The framing and carrying out of a policy will rest entirely with the management of the Bank. This is the positive aspect. The Act can, on the other hand, contain such provisions, which could decidedly hamper the development of a national economic policy. It will have, therefore, to be most carefully investigated whether the Bill does not include such details as might act in such an undesirable direction, and if such provisions are pointed out, their elimination from the Bill will have to be suggested.

If finally such a Bill will emerge out of the Legislatures, as will allow the unhampered growth of a national economic policy, the next step to be considered is, what the management can do in this respect. The details of a constructive policy will be outlined in Part III and now only a few general remarks can be made beforehand.

In the life of every nation, just as in the life of individuals, certain ideals must be the guiding stars, towards which, whether nations or individuals, must strive with all their energy. Such ideals are bound to gradually mould the evolution of all institutions of a nation. These distant ideals are unfortunately not always in accordance with the achievements of the day and there is not always a complete harmony amongst all sections of a nation as regards the ideals to be achieved.

The future constitution as outlined in the White Paper is surely not an ideal constitution and can rightly be indicated as a "compromise at the Centre". Bearing this constitutional aspect in mind one should not expect that an ideal Reserve Bank will emerge at the beginning as a result of a Reserve Bank Act, and much less under the present constitution. This seemingly unpleasant position should not discourage us and should under no circumstances induce us to give up the hope that by gradual evolution a Reserve Bank as near as possible to an ideal institution could be formed, but the right road should be mapped, out and the general principles should be laid down now.

The present stage of human history is generally noted for two characteristic features. *Firstly* at the end of the laissez-faire period we have reached a stage, when a certain economic planning is gradually carried out in all parts of economic life and *secondly* we are certainly living in a period when national and economic consciousness are stronger than ever before. We are living in a period of transition where all our ideals, our institutions and plans are in the melting pot. The world economic and financial crisis made matters far worse. Dozens, if not hundreds, of solutions have been proposed to find the way out of the difficulties. Could any one decide which is the right method ? Surely not and here the broad problem of the

Reserve Bank can be linked with these general considerations.

A Reserve Bank as indicated in Part I is the central pivot of the monetary and credit structure of the country. Exceptional stability of its operations and a steady evolution of its policy are basic conditions of its success. To make the Reserve Bank a laboratory of economic experiments would do unthinkable harm to the country. The right path to success may be formulated thus :—

The foremost duty of the management of the Bank should be, apart from the efficient conduct of the day to day business, to observe the general economic conditions of the country and to try to find out such lines of improvement which according to its experienced and mature judgement are for the ultimate benefit of the nation as a whole. Recent activities of the Bank of England* are an outstanding example of such a change of policy which not even the most radical reformers would have expected a few years earlier.

Apart from the initiative of the management of the proposed Reserve Bank of India it is the duty of all those who feel to have the capacity of taking part in the moulding of a better economic future of the country to present their ideas in a practicable form and to let them pass through the acid test of public opinion until all sides of the question are clearly seen.

Such efforts, no doubt, will gradually tend to direct the policy of the Reserve Bank towards higher ideals and towards adoption of such new lines as will be beneficial to the masses.

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*The Securities Management Trust, (1929) and the Bankers' Industrial Development Company, (1930) were instituted under the guidance of the Bank of England to enable finance to stand behind industry more systematically than before. See evidence given by Sir Ernest Harvey, Deputy Governor of the Bank of England before the MacMillan Committee, questions 828-860. Also the evidence of Sir W. Guy Granet q. 9028-9184. The evidence of Mr. Montagu Norman as regards industry is contained in his replies to questions 3317-3517.

CHAPTER II.

PRELIMINARY INCORPORATION SHARECAPITAL AND MANAGEMENT.

The next step to be undertaken now is to examine the Bill clause by clause. In examining the Bill first of all an explanation is necessary of all provisions which may appear complicated to the layman. It will often be necessary to sum up certain important points of the Bill which are not necessarily found under one and the same clause. Secondly the Bill in its present form will be criticised and possible alterations suggested within the present frame, or alteratively a change of principle will be advocated.

All matters involving questions of basic principles, furthermore the possible working of the Bank and the economic policy of the future will be discussed in Part III.*

§ 1. *The preamble.*

Para 3 of the preamble maintains the present monetary system as a temporary provision and the rupee remains linked to the sterling at a ratio of 1sh. 6d.

Representative Indian commercial opinion desires :— *either* to delink the rupee from sterling and allow the rupee to find its own level *or* to depreciate the rupee in terms of sterling *and* to relink it to sterling at a lower ratio, and to place an embargo on the export of gold.

§ 2. *Preliminary.*

Clause 1, sub-clause (4) lays down that Chapter III shall remain in force for a period of twenty-five years and

*Such clauses, sub-clauses or paras which are supposed to be clearly understood by layman, will not be dealt with, except if any criticism is to be expressed.

thereafter until repealed. Chapter III deals with the central banking functions, which may be rightly described as the most important functions of a Reserve Bank and consist chiefly of the provisions regarding the note issue, the reserves, the sale and purchase of sterling, the functions as bankers' to Government and the position of the Reserve Bank as a bankers bank. In Chapter I of this Book it has been sufficiently stressed, that we are living in a period of transition when all important institutions and principles are in a melting pot. If this is true in general it applies far more to currency matters than to anything else. In the course of the next 25 years all important principles as regards currency matters will change, no doubt, several times and therefore it is important to note, that the expression "shall remain in force for a period of twenty-five years" does not mean to say that the provisions of Chapter III of the Bill cannot be amended by the Indian Legislature during the course of the next 25 years. According to the provisions of the White Paper the Governor-General's previous sanction will be required to introduce Bills relating to amendments of the Reserve Bank Act and accordingly amendments can be made under the new constitution if there is an agreement on the subject between the Governor General and the two Houses of Legislature. Whether this provision of the White Paper will be sufficient in order to legislate according to the economic interests of the country will have to be seen during the course of the actual working of the reformed Legislature.

§ 3. *Incorporation, share capital, organisation and management.*

(*a*) *Sharecapital.*

According to the provisions of clause 4 the proposed Reserve Bank of India will be a Shareholders' Bank with a paid up share capital of five crores of rupees, divided into

shares of five hundred rupees each. The problem whether the Bank should be a State Bank or a Shareholders' Bank, will be discussed in Part III.

The shares, as proposed in sub-clauses (5) and (6) of clause 4, will be widely distributed all over the country and also in very small lots. The great significance of this proposal, coupled with the fact that no shareholder may have more than 10 votes (sub-clause (2) of clause 9 and sub-clause (2) of clause (14) will be emphasised later on.

The restriction of one shareholder's maximum votes to ten can be counteracted by *benami* transactions, which may so take place, that large shareholders distribute their shares in lots of twenty to their friends or employees who appear ostensibly as the holders of such shares and vote and act according to the instructions of the real proprietor of the shares.

Clause 50 of the Bill has been specially inserted to prohibit such transactions and to punish the offenders under para 2 of section 193* of the Indian Penal Code. It may however be considered that, it is in practice extremely difficult to prove such a case. There is for instance one possibility given by stating that such shares have been distributed as a present. Every body who gives a present can give instructions to the person to whom the present has been made, for the simple reason that instructions can also be given to such persons to whom no presents have been given.

Taking a practical view, however, it is not expected, that such *benami* transactions will play a great role in the future of the Reserve Bank.

(*b*) *The shareholders.*

Sub-clause (3) of clause 4 states the qualifications of the shareholders.

*Apparently "192" in the Bill is a clerical mistake.

As regards para (*c*) of sub-clause (3) it has to be pointed out, that on the strength of this para a large number of shares could pass unnoticed into the hands of such foreigners, foreign banks, corporations or companies as are neither domiciled in India, nor are British subjects ordinarily residents in India and are also not banks, corporations or companies as described in para (*c*). The possibility referred to is based on the fact that all or a majority of the shares of such companies, corporations or banks described in para (*c*) can be entirely held by foreigners, who are neither domiciled in India nor are British subjects ordinarily residents in India. There are to-day a good number of such companies actually working in India whose shares are entirely in the hands of foreigners. No doubt sub-clause (4) of clause 4 may act as a safeguard in this respect if the attention of the Central Board is drawn to this possibility. Furthermore a suitable extension of clause 50 in this direction could also be helpful to avoid this danger. Sub-clause (1) of clause 50 should be so amended as to authorise the Local Board to enquire into the nationality of the shareholders of such companies as hold shares of the Reserve Bank.

The Central Board may according to sub-clause (4) of clause 4 decline to allow shares or to register any transfer of shares, but it may be considered that in case of 1 lakh of shares it is rather difficult to control the entire position. Such foreigners who for whatsoever reason desire to exercise influence on the Reserve Bank, may for instance float hundreds of small limited companies under the Indian Companies Act, 1913 in various parts of India. It should not be forgotten that international financiers of an adventurous type like the late Ivar Kreuger, for instance, have carried out such interferences in foreign countries successfully on a much larger scale than the above described possibility.

It is recommended therefore that the Bill should provide suitable powers to the Central Board to forfeit a share when it is found that the same is held by a company registered under the Indian Companies Act, if the majority of the shares of that company is held by foreigners.

In this connection attention has also to be drawn to sub-clause (2) of clause 14, according to which votes at the general meeting may be exercised by proxy. If one of the objects of sub-clause (4) of clause 4 is to exclude undesirable persons, a modification is also required in clause 14, sub-clause (2), so that the undesirable person who is thus excluded may not attend a general meeting as a proxy. It is suggested therefore, that none but a shareholder should be entitled to act as a proxy.

(*c*) *Elections.*

The most important right of the shareholders, no doubt, is their function to elect the five members of every Local Board (para a, sub-clause 1 of clause 9) according to sub-clause (2) of clause 9. At this stage, however, it has to be repeated that one of the basic ideas of the Bill is to distribute the shares as widely as possible in the country and at the same time to limit the voting power of an individual shareholder to a maximum of 10 votes. This provision tends to avoid the possibility that large shareholders or groups of shareholders should exercise a decisive influence. This principle may be correct from the point of view of eliminating the possibility of the influence of a few large shareholders but this system has other most important consequences which can only be understood from a rather practical angle :—It is a well known fact that shareholders and specially holders of a few shares seldom attend the general meetings of joint-stock companies. This applies far more to the case of the proposed Reserve Bank as its shareholders will be spread all over the country and the

average shareholders will most certainly not take the trouble and incur the expense of travelling to Calcutta or Bombay or to any other Local Board in order to exercise one to maximum ten votes. Such shareholders, on the other hand, who have some special reason to attend the meeting in order to oppose the proposals of the management will organise the attendance of their followers with a certainty of a fairlyeasy success and will take the management by surprise. According to the provision of limited individualvotes most likely a very small number of shareholders could form a majority at a local meeting and also at a general meeting. Thus a small group of shareholders can easily elect its nominees as members of the Local Boards.

The elected members of the Local Boards will elect from amongst themselves the one or two directors representing their area. The great importance of the above described possibility may be stressed in this connection. The full significance of the elections will be discussed later on.

(*d*) *The Local Boards.*

The Local Boards will consist of the five elected members and further of three (or less) members nominated by the Central Board. As the majority (eight versus five) of the Directors will however be elected indirectly through the members of the Local Boards—on the basis of the majority of votes at the Local Boards, it has to be emphasised, that these members nominated by the Central Board will in fact also be the outcome of the result of the share holders votes. The Local Boards will have it is hoped—a great influence on the local credit policy of the Bank. The broad lines of policy will naturally be outlined by the Governor and the Central Board. The Local Board having a detailed knowledge of and great experience as regards local conditions it should be entrusted with the scrutinising of important matters of credit in its area. Sub clause

(7) of clause 9 prescribes that the actual duties of the Local Boards will be laid down by the Central Board. The Local Boards will also act as advisory bodies to the Central Board.

(*e*) *The Directors.*

There will be four Directors nominated by the Governor General in Council and eight Directors elected by the Local Boards. A government official nominated by the Governor General in Council will also be a Director but will not be entitled to vote. Including the Governor there will be thirteen members to vote at the meetings of the Central Board if all are present and as a consequence the eight elected Directors or even seven of them will hold the majority if they combine against the Governor and the four nominated Directors.

The re-eligibility of the elected Directors, as laid down in para 2 of sub-clause (4) of clause 8, is a sound principle so as to obtain a certain continuity and also in order to utilise the experience attainable through longer service than five years. An age limit should, however, be considered to give a chance to relatively younger prominent members of the various branches of the economic life of the country. It may be of interest to note that a retiring age of 70 was introduced as regards the Directors of the Bank of England in 1917.*

Considering Indian conditions the age limit may be fixed at 60 years. The same age limit shall also apply to the Members of the Local Boards.

Sub-clause (1) of clause 10 lays down the rules as regards, who can be a Director.

A remark seems to be necessary relating to para (*b*) of sub-clause (1) of clause 10. Para (*a*) prescribes that

*See Sir Ernest Harveys reply to Mr. J, M. Keynes (question No 114) before the MacMillan Committee.

only such persons may be Directors or Members of Local Boards who are or were for sometime engaged in the direction of agricultural, commercial, financial or industrial activities. This para very correctly limits the qualification of Directors and Members of Local Boards to such persons who are or were in a leading position of any branch of the economic life. Para (*b*) on the other hand cancels in fact the very sound qualification laid down in para (*a*), for any body can become a Director of any mushroom company within the shortest time without having had previously the slightest connection with or experience as regards agriculture, commerce, finance or industry.

The omission of para (*b*) is suggested accordingly.

Sub-clause (4) of clause 11 excludes members of the Indian Legislature and of the local Legislatures from the Central and Local Boards unless they resign their seat in the Legislatures. This provision, being a matter of principle will be dealt with in Part III.

(*f*) *The Governors and the Central Board.*

The Governor and the Deputy Governors will according to the proposals of the Bill —clause 8 sub-clause (1) (*a*)—be appointed by the Governor General in Council after consideration of the recommendations made by the Central Board, *i.e.*, the Governor General is not necessarily bound to appoint any of the nominees of the Central Board. The Governor-General in Council, on the other hand may remove from office the Governor or a Deputy Governor at any moment. This power reserved to the Governor-General in Council may make the Governor and the Deputy Governors of the Reserve Bank absolutely subordinate to the will of the Governor-General in Council and may create a position extremely difficult for the Governor as against

*Compare sub clause (1) of clause 11 of the Bill of 1928 readiug as under:
"The Governor General in Council may remove from offiee the Governor a Deputy Governor, on any resolution passed by the Board in that behalf by a majority consisting of not less than fifteen Directors."

the elected Directors* A deadlock can arise easily in connection with any decision where the elected directors, who form the majority of the Central Board hold different views as to the Governor of the Reserve Bank and the Governor General in Council. The four nominated Directors will be practically in the same position as the Governor as four of them plus the Governor will form a minority in case the eight elected Directors—or even only seven of them—hold different views. The power granted to the Governor General in Council in sub-clause (1) of clause 11 to remove an elected Director from office will in practice not likely be effective for the simple reason, that at least four of his fellow-elected Directors would have to vote against him, a situation not likely to arise if a matter of principle is involved.

Taking a broad view of the likely political evolution of the next few decades the possibility of such deadlocks may not be considered as a purely theoretical eventuality.

The most earnest consideration of the possibility of such a deadlock is recommended to the Joint Select Committee and also to the Legislative Assembly as well as to the Council of State. In any case a definite explanation should be obtained as to what will happen if the elected Directors oppose in every case the business policy of the Governor at the meetings of the Central Board.

Clause 13 deals with the meetings of the Central Board and reveals the position of the Governor versus his Directors. According to sub-clause (1) of clause 13, meetings of the Central Board shall be convened by the Governor at least six times in each year and at least once in each quarter. There are two matters of principle involved in this provision. *Firstly* the Governor alone shall have the right to convene a meeting of the Central Board and *secondly* if the Governor so wishes not more than six meetings a year will take place. The Directors will have no power to convene

meetings of the Central Board although they will have the right to convene general meetings at any time.

The policy laid down in this sub-clause will give practically dictatorial powers to the Governor. The management of a Reserve Bank requires no doubt a quick and decided handling of affairs. It is true that the Governor cannot possibly call a meeting when immediate action is required and specially not in India where the residence of the Directors will be spread all over the country and even a meeting convened by wire could not take place earlier than say three days after the event has happened, which requires immediate action.

The financial history of the last few years have furnished the world with several such important changes as require immediate decisions *e.g.*, the financial crisis in Central Europe in July 1931, the abandonment of the gold standard by Great Britain in September, 1931, the crisis in the U. S. A. since March 1933. It is true that dictatorial powers for the Governor are required in order to handle successfully emergency situations and that he could not possible postpone his action until the Directors could arrive from their far away residences.

It is, however quite another point of view from which the provision, that the number of meetings of the Central Board may be limited to six per year is criticised. The Board of Directors shall be in fact a consulting and advisory council of the Governor and accordingly six meetings could not possibly achieve this purpose. If the weekly meetings of the Court of Directors of the Bank of England are contrasted with these possibly not more than six meetings, as proposed by the Bill, the difference between the importance of the Court of the Bank of England and the Board of Directors of the Reserve Bank of India is fully characterised. The right that 7 Directors should have the

power of convening a meeting of the Central Board, should be given and the minimum number of meetings should be raised to once a month. It deserves notice that the Bill of 1927 provided for monthly meetings in clause 11.

There is, taking political possibilities into consideration as outlined above, a certain chance of the elected Directors taking up an attitude of opposition towards the policy of the Governor. Should the personal contact between the Directors and the Governor be limited to a few meetings a year only, there is little likelihood of achieving an atmosphere of understanding and compromise so necessary to carry on the functions of a fairly large body.

The Bill provides the Head Office to be established in Bombay (clause 6). Prominent Members of both Houses of the Legislature have most emphatically pointed out the undesirability of this arrangement and have advocated a perambulatory Head Office such as that of the Imperial Bank. Such a problem does not arise in countries with a distinct capital, where apart from Government headquarters all important business organisations of the country are concentrated. India has no capital in this sense. The economic structure of Bombay and Calcutta are entirely different and it would be most undesirable if the permanent Head office of the Bank would be located in Bombay and the general meetings of the Bank as well as the majority of the meetings of the Central Board would take place in that city. Therefore the suggestion that the Head Office should be perambulatory is strongly recommended. The General meetings and the meetings of the Central Board should take place alternately at places where the Head Office will be situated for the time being.

The mere fact that India has no distinct capital where at the same time business is centred too, will make the position of the Governor rather isolated. The management

of a Reserve Bank in charge of credit and currency matters of a country requires a most intimate contact with the Central Government of that country and specially with the Finance Department. Official records prove, that the Bank of England is in most intimate touch with the Treasury. Replying to a question (No. 454) of Lord MacMillan, Sir Ernest Harvey, Deputy Governor of the Bank of England, gave before the Committee on Finance and Industry the following vivid description of the relations of the Bank with the Treasury :—

"It (the Bank of England) is in daily touch with the Treasury, sometimes many times a day. Probably twice in the week.—if circumstances require it may be oftener—the Governor himself will pay a visit to the Treasury, sometimes accompanied by myself. When he is away, I pay such visits in his place. We have no secrets from them, we keep them fully acquainted as to the general trend of affairs in the City and the outlook as we see it..... The Treasury on the other hand, are good enough to reciprocate ; that is to say, that, whilst we keep them fully informed to the general trend of affairs in the City, as to any occurrences of importance affecting the position of finance and credit, they do not seek to dictate any alternative line of financial policy if we, in our judgment, consider a particular line of policy essential for the protection of the countrys' main reserves.....

Apart from these visits that I have spoken of, it is the practice for the Governor to visit the Chancellor of the Exchequer at fairly frequent intervals and to keep him fully informed. And I suppose I need hardly say that the colour of the Government of the moment has absolutely no influence whatever on the nature of these relations."

Unfortunately the Governor and the officials of the proposed Reserve Bank will have no chance of being similarly

in touch with the Finance Department of the Government of India, a drawback which can hardly be estimated in its entire consequences. Telephonic conversations and occasional visits to Delhi or Simla cannot have the same effect as an intimate and constant touch as described by Sir Ernest Harvey.

Apart from this intimate touch with the Treasury the Governor of the Bank of England enjoys further the facility of coming privately in touch with the Directors whenever he so wishes. Most of the Directors are in the City and available practically at a few minutes notice.

Personal influence of the Governor is also a factor which should not be underestimated, not only as regards the Directors but also in connection with the more important member banks. This aspect will be more fully dealt with in Part III.

The question of the number of Indian Directors and Governors will also have to be considered by the Joint Select Committee.

(*g*) *The General Meeting.*

Clause 14 sub-clause (1) deals with the general meeting and does not state the rights of shareholders, and accordingly it cannot be foreseen what may happen at a general meeting, where the majority of votes present are opposed to the proposals of the management of the Bank.

As explained above a fraction of the shareholders will be able to form such a majority.

The provision of the Bill that the Directors shall have no power to convene a Meeting of the Central Board, whereas they are to have the right to convene a general meeting at any time appears to be somewhat inconsistent. If, assuming that such a position might occur, that the majority of Directors will be in opposition to the Governor and his

followers, they will have the power to convene a general meeting at the shortest possible notice and they will most likely have a number of such shareholders in attendance, who will vote against the policy of the Governor. By such tactics the policy of the Governor, as opposed by the majority of the Directors can be made public at the general meeting, for the Directors in opposition will have a chance to instruct the speakers of the general meeting well in beforehand.

(*h*) *The first constitution of the Central Board.*

Clause 15 provides for the first constitution of the Central Board and prescribes that the first eight Directors representing the shareholders shall be nominated by the Governor General in Council. Thus the Bank during the first 4 years will be in fact a Government Bank,* although the possibility of a majority of opposition at the general meetings will still be open.

(*j*) *Conclusion.*

Summing up it appears that a Shareholders Bank as proposed in the Bill will not be "free from political influence" at all, though not in the *official sense* of the word, if political parties will make it their object to exercise influence at the elections of the Local Boards and at the general meetings. This problem will be fully analysed in Part III.

*The 4 Directors to be elected after 2 years in Bombay and Calcutta will form a minority as long as the 4 Directors representing the shareholders in Delhi, Madras, and Rangoon will not be elected 2 years later.

CHAPTER III.

THE BUSINESS OF THE RESERVE BANK.

Clause 17 enumerates all varities of business which the proposed Reserve Bank may transact. A detailed discussion of the provisions of this clause seems to be necessary.

§ 1. *Deposits.*

Sub-clause (1) of clause 17 authorises the Bank to accept money on deposit without interest from and the collection of money for Government authorities, Indian States, banks *and any other person.*

The last four words of this clause indicate, that it is the distinct intention of the framers of the Bill to allow the Reserve Bank to deal directly with any client. Although the acceptance of deposits free of interest may be claimed to be a non-competitive business, it is submitted that the authority to accept deposits from the public, though free of interest, will induce many persons and companies to keep cheque-accounts with the Reserve Bank.

As an actual proof of this assumption it may be stated, that at present the Imperial Bank of India grants no interest on cheque accounts and still the number of cheque accounts with the Imperial Bank is very considerable. Apart from business considerations vanity will play an important role in inducing many persons to have an account with and a cheque book from the premier Bank of the country.

Sub-clauses (4), (6) and (9) contain provisions, which will allow the Reserve Bank to compete with the member

banks. This point will be fully dealt with in connection with sub-clause (4). It deserves, however, notice at this juncture that apart from the fact that the member banks will have to be absolutely safeguarded against the competition of the Reserve Bank, it would not be advantageous if the staff of the Reserve Bank would be distracted from its high duties by the petty affairs of daily business with clients. It would also involve considerable expenditure to deal with thousands of small accounts.

The argument may correctly be advanced, that the Reserve Bank is not compelled by sub-clause (1) to accept deposits, but it may be considered that a refusal of clients of average good standing might easily lead to a bitter feeling, which would surely not be to the advantage of the Reserve Bank.

It is suggested in view of the above reasoning to omit the last 4 words of sub-clause (1) of clause 17.

§ 2. *Purchase, sale and rediscount of bills of exchange and promissory notes.*

Sub-clause (2) of clause 17 frames the rules of what is hoped to become the most important business of the proposed Reserve Bank *i.e.*, the rediscount of bills of exchange and promissory notes based on (*a*) commercial transactions, (*b*) agricultural operations or the marketing of crops and (*c*) drawn against the security of gilt-edge. The outstanding importance of the possibility to introduce rediscounting facilities in India, makes it necessary that this subject, which is not fully understood in this country, should be dealt with in all details as a separate Chapter in Part III.

§ 3. *Sale and purchase of sterling.*

Sub-clause (3) of clause 17 authorises the Reserve Bank to sell and buy sterling and sterling bills of exchange.

The provision that the minimum amount so transacted shall be not less than the equivalent of one lakh of rupees is sound, for such exchange business will not be transacted with ordinary clients.

It may however be considered whether the provision that apart from the member banks persons approved by the Central Board should also enjoy the possible advantages of dealing in sterling directly with the Reserve Bank will not be to the detriment of the foreign exchange business of the member banks and especially whether it will not hamper the development of the exchange business of Indian Joint Stock Banks, as just the most important clients will very likely be granted the privilege to deal directly in sterling with the Reserve Bank.

Attention may be drawn to the last few words of this sub-clause :—

".....and the keeping of balances, with banks in such countries ;"

These words seem to indicate that the Reserve Bank is to be authorised to open accounts with commercial banks in sterling standard countries, whereas sub-clause (13) states that the Reserve Bank may open an account with any other bank which is the principal currency authority of a sterling standard country. The provision of sub-clause (13) does not preclude the Reserve Bank of opening an account with commercial banks in sterling standard countries and clause (19) contains also no such prohibition, but it may be argued that sub-clauses (3) and (13) give rise to a rather peculiar contrast. The practical importance of this aspect consists in the fact that it would naturally be more advantageous from the point of view of profit if accounts with foreign commercial banks could be opened for the sake of obtaining interest on sterling balances, for banks on the other hand, which are the principal currency authorities of their country *i.e.* Central Banks, usually pay no

interest. Sub-clause (13) seems to indicate Central Banks for the sake of security. At the time of drafting of sub-clause (13) it has been apparently overlooked that the last line of sub-clause (3) mentions the word "banks" without any further restriction. It will be useful to clear this point at the Committee stage.

The provisions of this sub-clause should not be confounded with the obligation of the Reserve Bank to buy and sell sterling at fixed rates *i.e.*, at 1sh. 6-3/16d. and 1sh. 5.49/64d. respectively, as laid down in clause 40 and 41. Two entirely different functions of the Reserve Bank have to be clearly distinguished in this connection. Clause 40 and 41 refer to central banking functions of the Reserve Bank and compel the Bank as currency authority to maintain the rate of foreign exchange of the rupee at a theoretical rate of 1sh. 6d. In practice the fluctuations of the rupee sterling exchange will be limited between an upper point of 1sh. 6.3/16d. and a lower point of 1sh. 5.49/64d. Rupee and sterling being off gold these lower and upper points can naturally not be described as "gold points" for no in or outflow of gold will be connected with the reaching of these two rates. Although off gold a certain automatic working will be manifest, for instead of gold, sterling will flow in and out of the country on touching these points. The details of this phenomenon will be explained in Part III when the likely working of the sterling exchange standard will be described.

Sub-clause (3) of clause 17, on the other hand, authorises the Reserve Bank to sell and purchase sterling as part of its banking business. Such transactions will be necessary first of all in order to transact the remittances of the Government of India to meet the Home Charges. Furthermore open market operations (See page 39) may also be carried out with the help of the sale or purchase of sterling. Changes in the sterling reserves may also neces-

sitate the sale or purchase of sterling and under certain circumstances the Reserve Bank may also invest part of its assets in sterling securities. Whereas the purchase and sale of sterling in order to maintain the rupee rate between the fixed upper and lower points may only take place at the rates stated in clause 40 and 41, the sales and purchases, on the other hand under sub-clause (3) of clause 17 may be effected at any rate within the limitations of the fixed upper and lower points according to the daily business situation. Summing up it deserves notice that the Reserve Bank will carry out two distinctly different sorts of transactions as regards the sale and purchase of sterling :—

(1) The maintainance of the rupee-sterling exchange between the upper and lower points according to clause 40 and 41 acting as currency authority and

(2) Buying or selling sterling at any convenient rate between the fixed upper and lower rates in order to carry on its various banking functions.

§ 4. *Loans and advances.*

Sub-clause (4) of clause 17 enumerates under five heads the securities against which the Reserve Bank may make loans and advances, repayable on demand or on the expiry of fixed periods not exceeding ninety days against the security of :—

(*a*) Trustee securities.

(*b*) Gold.

(*c*) Such internal bills of exchange or promissory notes as are eligible for purchase or rediscount by the Bank.

(*d*) Sterling bills of exchange and treasury bills of sterling standard countries and finally,

(*e*) Such promisory notes of member banks or provincial co-operative banks as represent cash credits granted by these banks and as are supported by documents evidencing the title to goods.

The Reserve Bank will be apart from its capital in charge of large funds accruing partly from the deposits of various public bodies as enumerated in sub-clause (1) of clause 17, and partly from the compulsory deposits of the Member Banks and as a consequence the Bank should be authorised to carry on every possible kind of transaction in order to invest these large funds securely. Paras (*a*), (*b*), (*c*) and (*d*) require no further explanation. The entirely new business possibility on the other hand, created by para (*e*) is of great importance and will, no doubt be most helpful in overcoming the monetary stringency of the busy season in this country. This difficulty was not fully eliminated by the emergency currency created on the basis of section 20 of Act X of 1923 because eligible hundis were not forthcoming in the necessary quantities and secondly according to the rules connected with the institution of emergency currency the bank rate had to reach an unpleasently high level before emergency currency was issued. The credit facilities to be granted under para (*e*) shall be available, as proposed by the Bill—only for the first five years of the working of the Reserve Bank. The reason for this time limit consists in the hope that during these first five years a bill market will develop in India and that as a consequence cash credits will be replaced gradually by commercial bills. The outstanding importance of the provision contained in para (*e*) will be further discussed and explained in Part III in the chapters on banking and money market.

§ 5. *Should the Reserve Bank compete with the scheduled banks.*

The possible competition of the Reserve Bank with its member banks has been stressed in para 1 of this chapter

in connection with deposits which the Reserve Bank may accept from "any other persons" and it has been mentioned that this aspect will be fully investigated at the time of the examination of sub-clause (4).

A glance at this sub-clause will reveal the fact that out of the five heads under which the Reserve Bank will be authorised to grant loans and advances only the first two paras *i.e.*, (*a*) and (*b*) contain a possibility to give these loans directly to clients against the security of giltedge (trustee-securities) and gold. It is evident that loans against securities as required under paras (*c*) and (*e*) can only be granted to scheduled Banks.

As regards para (*d*) it is not quite clear whether the Reserve Bank can grant loans on the security of sterling bills of exchange to scheduled banks only, or also to the "persons approved" by the Central Board. One is rather inclined to believe that it is the intention of the Bill to authorise the granting of such loans not only to scheduled banks but to the "persons approved" too, for the principle seems to prevail throughout the Bill that the Reserve Bank shall have the right to transact business directly with clients. The business possibility contained in para (*d*) is not to be underestimated, for it applies to the most important exporters, who were up to now on the approved list of the Controller of the Currency in connection with Council Bills. These prominent business houses will welcome to take a loan from the Reserve Bank at the lowest possible rate of interest in case they hope that their sterling holdings will appreciate during the next few weeks, a position which may on some occasions be expected, when the balance of trade is on the adverse side.

In order to avoid any misunderstanding when the Reserve Bank will actually function it is suggested to make this ambiguity clear.

Should, however, the proposition be accepted that

apart from exceptional cases, the Reserve Bank shall not be authorised to deal with clients directly, this problem will not arise.

Finally the question has to be faced as a matter of principle whether the Reserve Bank shall be allowed to deal directly with clients and thus compete with the scheduled banks or not.

A glance at the oral evidence of Sir Ernest Harvey before the MacMillan Committee in this respect may again be of great interest.

The statements made by the Deputy Governor of the Bank of England as regards dealing with clients directly may be summed up as follows :—

Central Banks (Reserve Banks) should have the liberty to engage in ordinary banking business, a liberty which they should not necessarily exercise. (q. 33). The authority to do business with clients directly, should be utilised if for example for any reason credit facilities are not available elsewhere. (q. 31)* In general the principle should be not to compete with other banks for private bank business. (q. 318).

The most important remark made by Sir Ernest Harvey in this respect, which has also a general importance regarding the business policy of the Bank of England was the undernoted statement :—

".....in times of national danger or crisis, I am not prepared to say that there is anything that the Bank would not do if it were really in the national interest and consistant with its primary duties to the community" (q. 319).

Mr. Montagu Norman, Governor of the Bank of England giving evidence before the Hilton Young Commission said :—

*Mr. McKenna remarked ".....to meet a case in which all the other ordinary commercial banks conspire, or, in fact, do not give credit in a particular instance" (q. 52).

"I should certainly make no provision which would prevent the Central Bank (Reserve Bank), if it thought necessary, from competing with the other banks. It might be very necessary to do so".

It is important to add that Mr. Montagu Norman's remark points to open market operations, when the Reserve Bank wishes to make its policy effective.

Sir Osborne Smith pointed out before the Central Banking Enquiry Committee that :—

"Generally speaking however a Reserve Bank controlling currency should not compete with trading banks or risk such business".

"I consider it absolutely essential to the control of credit that the exchange and other member banks must keep an adequate substantial percentage of their call and time liabilities with the Reserve Bank and this is primary reason why the Central Institution (*i.e.*, the Reserve Bank) should be debarred from doing ordinary business." (Pages 848 and 849, Volume II Indian Central Banking Enquiry Committee, 1931, Evidence.)

Dr. Trip, President of the Netherland Bank, remarked in his evidence before the Central Banking Enquiry Committee :—

"My opinion is that the Reserve Bank should not compete with other banking agencies in order to make profits—on the other hand when it is necessary to enforce their policy in the interest of the country, the Reserve Bank ought to be in a position to go to the open market. (Indian Central Banking Enquiry Committee, 1931, Volume IV Discussions with foreign experts. (Pages 395-396).

The fear no doubt of a possible powerful competitor will induce the prospective scheduled banks to try their best and obtain such modifications of the Bill as will distinctly debar the Reserve Bank from the possibility of competing with the scheduled banks.

Considering, however, the above opinions of most experienced experts one is inclined to be driven to the conclusion that the Act should not altogether exclude every business possibility to be transacted with clients—apart from clause 18, which is expressly included in order to enable the Reserve Bank to carry out open market operations—it is suggested that, a general remark should be inserted—possibly at the end of clause 18—to the extent that the Bank should do direct business with clients only in case of emergency but not in course of its day to day business. The proposition, however, made in connection with sub-clause 1 of Clause 17 should be possibly carried out for it appears from every practical point of view to be entirely unnecessary that the Reserve Bank should open thousands of small accounts, as such a provision cannot possibly be connected up with open market operations. As open market operations are only of a temporary nature it may be proposed, that the Reserve Bank should not open any permanent accounts to clients and that all accounts which had to come into being in connection with open market operations should be liquidated and closed as soon as the underlying motive has ceased to exist.

It may be added that the above suggestion namely that a remark should be added to clause 18, advising that direct business with clients should only be done in case of emergency, is based on an analogy regarding a recommendation—in certain Central Bank Charters—that the Bank should possibly not discount commercial paper bearing two signatures only, but should, as a rule insist on 3 signatures.*

* See for instance:- National Bank of Hungary:- "Normally three. but in any case two signatures must be on bill. Sir C. H. Kisch, Central Banks, fourth edition, Page 313. Austrian National Bank, same provision as in case of Hungary, Kisch page 19, also zechoslovakia, page 241 etc. It seems that this arrangement was generally accepted by the new Central Banks in Central Europe and accordingly there is a precedent that an Act establishing a Reserve Bank makes a recommendation, but leaves it to the management to act according to its judgement.

§ 6.–*Miscellaneus business.*

Sub-clause (5) provides for ways and means advances to Government with a time limit as safeguard of liquidity.

Sub-clause (6) authorises the Bank to issue demand drafts and bank post bills, *i.e.*, to give facilities for internal remittance. If such drafts and bills are sold by the Reserve Bank to ordinary clients it would mean serious competition to the scheduled banks. The above remarks regarding competition with scheduled banks apply here too. The point of open market operations could scarcely come in here in the ordinary meaning, apart from the rather unlikely eventuality that the scheduled banks would charge too high rates for internal remittance and the Reserve Bank would consider it to be its duty to step in and break down the high rates.

Sub-clause (7) provides for the sale and purchase of Government securities of sterling standard countries maturing within five years.

The Reserve Bank will buy sterling securities partly to increase its sterling reserves and partly to make investments utilising balances of the Banking Department.

Sub-clause (8) deals with the purchase and sale of rupee Government securities. The Bank will effect such purchases and sales probably for three reasons :—

(*a*) To be held as reserves against the note issue as an asset of the Issue Department.

(*b*) For the sake of investment in the Banking Department and

(*c*) To carry out open market operations by selling and buying gilt-edge.

Paras (*a*), (*b*), (*c*) and (*d*) prescribe the proportion of the maximum quantity of gilt-edge to be held by the Banking Department on a sliding scale with regard to maturity.

Sub-clause (*a*) authorises the Reserve Bank to accept articles of value, securities etc., on safe custody and to collect dividends etc., on such securities. Such business is decidedly clients' business and can under no circumstances be connected with open market operations. It is furthermore an extremely petty sort of business so that it is hoped that the Reserve Bank will not carry on this business with ordinary clients, who would be greatly attracted to use the safes of the newest and probably best built bank.

Sub-clause (11) enumerates such business transactions, which the Bank will be authorised to carry out as the agent of various Government authorities.

Sub-clause (12) authorises the Bank to buy and sell gold coin and bullion. The implications of gold transactions will be examined in connection with clause 33 (4).

Sub-clause (13) has been dealt with in connection with sub-clause (3). It is customary that Reserve Banks act as each others' agents or correspondents.

Sub-clause (14) authorises the Bank to borrow money for a period not exceeding one month with the restrictions that in India the Reserve Bank shall borrow only from scheduled banks and outside India only from Central Banks (Reserve Banks). The remark has been passed in some quarters that under what circumstances could a Reserve Bank come into a position to have to borrow from its scheduled banks. It is indeed practically unthinkable that such circumstances could possibly arise. A Reserve Bank is the chief source of credit in the country and it is most unlikely that at times when scheduled banks are willing to lend at low interest rates—for it is assumed that the Reserve Bank will not pay a high rate of interest under this sub-clause—that at the same time the Reserve Bank will have some or the other reason to borrow money for a period of maximum one month from a scheduled bank. If this sub-clause has just only been inserted to authorise

every possible business that may occur in theory it would not do any harm but the fact that if such a case happens in practice it may be lead to unpleasent jealousy amongst banks speaks rather against this provision.

Dr. Trip has expressed his opinion that this business possibility may be omitted.

The underlying motive of this sub-clause should be made clear at the Committee stage in any case.

As regards borrowing from foreign Central Banks it is rather peculiar that the Reserve Bank according to sub-clause (3) may keep balances with any bank in sterling standard countries, whereas borrowing is restricted to Central Banks only. Foreign borrowing may become necessary in order to tide over for a short period of adverse foreign balances of trade and payments as mentioned on page 19.

Sub-clause (15) states that the Reserve Bank may make and issue bank notes. The detailed regulations of note issue are contained under "Central Banking Functions".

Clause 18 authorises the bank to purchase, sell or discount bills of exchange without the signature of a scheduled bank or a provincial co-operative bank for the purpose of regulating credit in the interest of Indian trade, commerce, industry and agriculture. This power of direct discount is proposed to enable the Bank to carry out open market operations in order to make its policy effective if necessary against the will of the scheduled banks. Such a provision is unavoidably necessary, for the experience of the last decade all over the world proves that changes in the bankrate alone are not always effective. This provision cannot be regarded as a power to compete with banks as such authority has to be given to the Reserve Bank to carry out an often unpleasant task for the sake of higher considerations. The power is given to the Central Board, which in turn may be delegated to the Governor. The Bill

of 1928 reserved this right to the Central Board. Every body who is conversant with the practice of open market operations is bound to welcome the possibility that the Central Board can delegate this power to the Governor for the simple reason that open market operations have to be carried out without delay sometimes even by issuing orders to brokers on the telephone. If—as would have been the case under the Bill of 1928—a meeting of the Central Board would have had to be convened first, the situation which could have been remedied by immediate action, would have had to be allowed to grow worse before the Directors would have arrived from their distant residences. Whether in the absence of a bill market such open market operations can be carried out in the near future is an entirely different question. This aspect and other connected points will be examined in Part III.

Clause 19 enumerates the business which the Bank may not transact. These prohibitions are so framed as to keep the business of the Reserve Bank as liquid and as secure as possible. There is only one point to explain. According to sub-clause (4) of this clause the Bank may not make unsecured loans or advances except (see first and second line of this clause) as provided in clauses 17, 18 and 43. Clauses 17 and 18 authorises the Bank to purchase or discount respectively rediscount bills of exchange and promissory notes. Such transactions are only secured by what is judged to be good signatures *i.e.*, no tangible security is prescribed.

In consequence of clause 43 the Reserve Bank will allow balances to the Imperial Bank as stated in the Third Schedule as a compensation for the loss of part of its present business with Government. The Imperial Bank will have not to give securities against these advances and accordingly such advances will come under the category of unsecured loans.

CHAPTER IV.

CENTRAL BANKING FUNCTIONS.

The specific functions of a Reserve Bank *i.e.*, the note issue, the maintainance of the reserves in accordance with the rules laid down by law, the maintainance of the rate of foreign exchange within the limits fixed by law, the rights and duties as bankers to Government and finally the keeping of compulsory reserves of scheduled banks are stated in this chapter.

Clause 20 and 21 contain the rights and duties of the proposed Reserve Bank of India as bankers to Government and need no further explanation.

A detailed analysis and criticism of clauses 22 to 43 will be attempted now.

§ 1. *The note issue.*

The Reserve Bank will have the sole monopoly to issue bank notes in British India and shall take over accordingly this function from the Governor General in Council. Certain rules and explanations regarding a period of transition of one year are laid down in sub-clause (1) and (2) of clause 22.

The issue of bank notes will be conducted by the Bank in a separate Issue Department as detailed in sub-clause (1) of clause 23.

The fact that the MacMillan Committee recommended the amalgamation of the Issue Department of the Bank of England with the Banking Department, has given rise to the expression of a criticism of the proposition of the Bill to have two separate Departments.

It may, however, be considered that the establishment

of a Reserve Bank in India is decidedly an experiment and it is accordingly felt, that it may serve a useful purpose to keep the accounts relating to note issue separately. *First* of all the position of this specific central banking function can far better be controlled by the public on the basis of the separate weekly returns of the Issue Department, as laid down in the Fifth Schedule, than otherwise, and Secondly if the Reserve Bank proves to be a failure and the Governor General in Council would have to exercise the power granted to him in clause 30 and take over the note issue from the Reserve Bank, it will be much simpler to carry out this unpleasant task if the accounts as well as the assets and liabilities of the Issue Department are kept separately.

Bank notes will be issued by the Reserve Bank against the *Purchase* of gold, sterling, Government securities, bills of exchange, promissory notes and also *in exchange* for rupee coin and bank notes (sub-clause (2) of clause 23).

On the gold standard notes are issued partly against the purchase of gold partly against securities. The notes issued against securities form the fiduciary issue, which can be a fixed fiduciary issue or a proportionate fiduciary issue as explained on page 39 to 41. The reserves on the gold standard are accordingly divided into metallic reserves and security reserves. The Indian currency standard at present is a sterling exchange standard and this will also be the standard when the Act comes into operation as a temporary provision, as indicated in para 3 of the preamble.

Theoretically speaking a sterling exchange standard requires no gold reserves at all and the fact that the maintainance of a minimum gold reserve is proposed by the Bill is the outcome of entirely different considerations as will be explained below. Under a sterling exchange standard the role of the gold reserves is displayed by sterling reserves, for the simple reason that under such a standard

the rupee is linked to and stabilised in terms of sterling and not in terms of gold and as a consequence the maintainance of the rate of foreign exchange is achieved by the sale and purchase of sterling as proposed in clause 40 and 41.

On the strength of the above explanation it will be convenient to subdivide the reserves held against the note issue into three groups :—

(1) The sterling reserves.
(2) The gold reserves and
(3) The rupee security reserves.

The sterling reserves will include all items enumerated in sub-clause (6) of clause 33. It has to be mentioned, however that though sterling holdings will be chiefly held in the form of sterling securities, these sterling securities, are not securities in the meaning of the "security reserve". Sterling securities are held as a reserve in order to maintain the convertibility of the rupee into external means of payment and accordingly these sterling securities, represent foreign means of payment. "Security reserves" on the other hand are the rupee securities *i.e.*, the internal securities held as reserve against the fiduciary issue.

Clauses 24, 25, 26, 27, 28, 29, 30, 31 and 32 contain miscellaneous provisions and need no further explanation.

It may only be remarked that the reason of sub-clause (2) of clause 26 seems not to be quite clear and can when, brought into practice, cause enormous trouble to trade and commerce. It should be considered, that buying agencies of raw products of the country are bound to hold large sums in cash in remote up country stations when the marketing of crops take place. Should, in consequence of a notification issued by the Governor General in Council on the basis of this sub-clause be declared, that a certain series of bank notes will cease to be legal tender and should, by mere chance, at that time a considerable number of bank notes

of that series be with such a buying agency, it is evident that the commercial activities of this agency will have to suffer not only for the reason that all such notes will have to be sent to a branch or agency of the Reserve Bank which may be at a distance of hundreds of miles of such a buying agency, but also because the sellers of raw produce will try to force—though without legal foundation—the buying agency to exchange the bank notes paid out to them previously, which has ceased to be legal tender. An explanation of the objects and reasons of this sub-clause seems to be of great importance at the Committee stage of the Bill.

Should the insertion of this sub-clause be an attempt to re-install the now defunct circle-system of note issue, it could rightly be described as a retrograde step, which is not in harmony with modern currency requirements.

It may be added, that the statement of Objects and Reasons of the Bill of 1927 contains on page 2 the following remark as regards this sub-clause :—

"It is, however, proposed to take power for the Governor General in Council and the Bank to call in notes of particular series, if necessity arises."*

The possible reason of such a necessity is however, not stated. An explanation, as mentioned, above would be helpful to clear this point.

§ 2. *The reserves.*

The assets of the Issue Department—states the Bill in sub-clause (1) of clause 33,—shall consist of gold coin, gold bullion, securities of sterling standard countries, rupee coin and rupee securities to such aggregate amount as is not less than the total of liabilities of the Issue Department.

The liabilities of the Issue Department, as defined in sub-clause (1) of clause 34, are an amount equal to the

*This power, as mentioned in the statement of Objects and Reasons has, however, not been proposed in the Bill to be granted to the Bank.

total of the amount of notes in circulation. The value of the total of notes in circulation at a certain moment is an amount expressable in terms of rupee, whereas the value of the assets held in the reserve varies according to the fluctuations of the price of sterling and various securities. Say, for instance, that the amount of notes in circulation remains constant for a period of three days, it is evident that the value of the assets will not remain unchanged, for the prices of exchanges and securities vary from hour to hour.

In order to overcome this practical difficulty Reserve Banks go on valuing their assets at purchase price, and accordingly it is recommended that the following words should be inserted after the word "amount" in sub-clause (1) of clause 33 :—

".....amount, *calculated on the basis of the purchase price*, as is.....".

Sub-clause (2) of clause 33 proposes that 40% of the total assets shall consist of gold or sterling.

Considering recent propositions of international conferences and chiefly the recommendations of the Report of the Gold Delegation of the League of Nations, this minimum percentage of 40% seems to be on the high side and might stand in the way of any reasonable expansion of currency as will be discussed in Part III.

The Report of the Gold Delegation (1932) recommended in para 212 that the reserve ratios should be reduced from their present high level to, say, 25 per cent.

It is also customary to compare the reserve ratio with the possible adverse balance of trade and payment of the country. Taking the total of notes circulating at Rs. 180 crores, a reserve ratio of 40% means that 72 crores of gold and sterling reserves are to be held against the actual volume of notes in circulation. It appears to be somewhat on the high side to have such a large amount of foreign means of

payment as reserve in view of the fact that the total visible foreign balance of accounts in the worst year of the crisis was 1967 lakhs of rupees in favour of India.*

It deserves furthermore special attention that a Note of Dissent to the above Report, signed by Mr. M. A. Janssen, Sir Reginald Mant and Sir Henry Strakosch has given the undermentioned recommendation :—

".....we are of opinion that the legal regulations of percentage reserves should be abolished and that it should be left to each Central Bank to consider what amount of gold it thinks appropriate to meet the demands which are likely to arise". (page 71)

The second para of sub-clause (2) of clause 33 provides that the value of gold reserve shall be not less than thirty five crores of rupees.

A few remarks have been made above about gold reserves in connection with a sterling exchange standard and it has been stated that no gold reserves are, in fact, required on a sterling exchange standard. It may be considered, however, that the problem whether the world at large will return to gold or not is absolutely open and that the trend of evolution in this respect cannot be reasonably forecasted. It is true that the arguments against the possibility and also against the desirability of a return to gold carry certainly some weight, but it should be remembered that there is a world of difference between economic theory and practical legislation. The fact that all countries, whether on or off gold standard, are trying to increase their gold reserves and the psychological factor, that the average man on the street believes that a paper note is only sound if there is a gold reserve behind it indicates the necessity of maintaining gold reserves, the more that should a restoration of the gold standard take place

* See, Report of the Controller of the Currency for the year 1932/33, page 47.

it would meet with great difficulties to establish a fresh gold reserve at that time. The size of such a gold reserve under present circumstances can only be an arbitrary figure. Para 24 of the Report of the Committee on Indian Reserve Bank Legislation may be read in this connection.

The remainder of the assets will consist of rupee coin, Government rupee securities, bills of exchange and promissory notes (sub-clause 3) with the provision that the assets held in Government rupee securities shall not exceed one fourth of the total amount of the assets or fifty crores of rupees, whichever amount is less.

In order to understand the significance of this limitation it may be noted that the law actually in force (section 2 of Act II of 1925) provides Rs. 100 crores as an upper limit for the holding of Government rupee securities.

The reduction of the amount of Government rupee securities is based on the desire that with the working of the Reserve Bank the expansion of currency shall take place against the purchase or rediscount of bills of exchange or promissory notes. This principle is very sound and will be further explained in Part III.

Sub-clause 4 lays down the method of valuation of the reserves. Gold will be valued as if the rupee were on the gold standard and accordingly 8.47512 grains of fine gold shall be valued at one rupee, which is equal to a price of gold of Rs. 21-3-10 per tola of fine gold.

As the price of gold is fluctuating at present, being off the gold standard, some fixed rate had to be taken for the purposes of accounting and accordingly the rate fixed in Act IV of 1927 has been maintained.

Rupee coin shall be valued at its face value, *i.e.*, a one rupee coin shall be valued at one rupee, although the silver contents are only about half at present. It may be remembered, however that the rupee coins in the reserves are only meant for internal convertibility of the note issue and

for this purpose it is perfectly correct to take the value of a rupee coin at one rupee. Gold in fact will be undervalued by about 36% whereas silver will be overvalued by about 100%. Under present conditions this difficulty is unavoidable and some or another imperfect solution had to be adopted. There is no reason to maintain that the system as regards the valuation of gold and silver is unreasonable. The provision of the same sub-clause, on the other hand, that securities shall be valued at the market rate for the time being obtaining is decidedly open to criticism for the simple reason that the market rate is constantly fluctuating. Instead of taking the market rate as the basis of valuation it is recommended to take the purchase price.

Sub-clause (5) proposes to lay down the rule that 85% of the gold reserves shall be held in British India. This proportion is about equivalent to the actual position.

Sub-clause (6) enumerates the various forms in which sterling assets can be held.

Clause 34 gives the definitions of the liabilities of the Issue Department.

Clause 35 provides for the changeover when the note issue will be handed over by the Governor General in Council to the Reserve Bank. The note issue will be taken over as a whole and will constitute the initial liability of the Issue Department. Against this liability the Governor General in Council shall transfer the necessary assets. The present Paper Currency Reserve and the Gold Standard Reserve form these holdings of the Government of India out of which such assets will have to be handed over to the Reserve Bank as will comply with the prescriptions of clause 33 of the Bill.

It is however proposed that half of the assets shall consist of gold and sterling and the rupee coins transferred shall not exceed fifty crores of rupees. Although a gold and sterling cover of 40% is only required according to the

Bill, the transfer of 50% is provided for, to be on the safe side, as recommended by the Hilton Young Commission.

After the establishment of the Reserve Bank a large amount of the rupee coins held at present in the Reserve will remain in the hands of the Government of India.

Clause 36 provides for the regulation of the rupee holdings of the Issue Department.

The last but one line of sub-clause (2) of clause 36 contains a seemingly clerical error. The third words of this line should be :—

"Its" instead of "his".

The expression "his" would refer to the Governor General whereas it is obvious that the consent of the Reserve Bank is meant to be given.

Clause 37 deals with an emergency case for which in every Central Bank statute a sumular provision is contained. Should, namely, in times of stress an excess note issue be necessary in order to meet exceptional requirements such notes may be issued on the basis of this clause. The bank will have, however, to pay a tax to the Governor General in Council on the notes so issued.

Clause 38 prescribes that the Governor General in Council shall not re-issue rupees nor put any new rupees into circulation out of its rupee and silver bullion holdings, but may sell the rupees as silver bullion. The Reserve Bank on the other hand will not be authorised to sell its silver holdings.

Clause 39 deals with the obligation of the Reserve Bank to supply different forms of currency and needs no further explanation.

Clauses 40 and 41 lay down the obligation of the Bank to purchase and sell sterling in order to maintain the stability of the rate of foreign exchange. These clauses have been fully explained on page 67.

Clause 42 provides for compulsory cash reserves to be kept by the scheduled banks with the Reserves Bank. The significance of this clause will be discussed in Part III.

The contents of chapter IV, General Provisions need no explanation nor is any remark felt to be offered, apart from the provision regarding the bank rate which will be discussed in Part III.

Part III.

The possible working and the problems of the proposed Reserve Bank of India.

CHAPTER I.

THE CURRENCY AND EXCHANGE PROBLEMS.

Reply has now to be given to the questions, how will the Reserve Bank work and whether it can be beneficial to the country. It is generally known that a Reserve Bank is in control of the currency, exchange and credit system of the country and accordingly before the actual working of the Bank can be depicted it is necessary to cast a glance at the proposed currency and exchange mechanism as compared with the present. The next step, after an analysis of the currency and exchange system has been undertaken, will be to enter into the jungle of the credit problem, which coupled with the problems of the banking structure, form the basic questions of a better future.

§ 1. *The present currency and exchange system.*

(*a*). *The Indian currency system on the gold standard.*

After the post-war currency chaos, the foundations of a regulated currency were laid down by Sir Basil Blackett, whose first achievement was to get an Act passed by the Legislature "to consolidate the law relating to the Government Paper Currency". This Act X of 1923 has brought a certain system into the then existing currency regulations, which were spread over a number of Acts, and Notifications not understandable even to the expert. Act X

of 1923 is up to now the foundation stone of our paper currency system and is now proposed to be replaced by the Reserve Bank of India Act, 1933. Act X of 1923 was amended by Acts XXXVI of 1923 and II of 1925. The gold standard was introduced on 1-4-1927 based on Act IV of 1927. These four Acts were the basis of the position on the gold standard from 1-4-1927 up to 21-9-31. A short summary of the Indian currency situation on the gold standard seems to be necessary :—

The system introduced by Act IV of 1927 was a gold bullion standard in theory, a gold exchange standard in fact. The price of gold was fixed at Rs. 21.3. 10. per tola of fine gold, which is equal to 8.47512 grains of fine gold per rupee. This gold equivalent of the rupee is exactly 50% higher than was the gold equivalent of a shilling, *i.e.*, a twentieth part of a gold sovereign. The rupee was, as a consequence, equal to one and a half shilling. This is the actual gold basis of the 1sh. 6d. (eighteen pence) ratio.

In order to maintain this parity the Controller of Currency was compelled to buy gold at Rs. 21.3. 10. per tola of fine gold in quantities of not less than 40 tolas (Section 4 of Act IV of 1927) and to sell gold at the same price in quantities of not less than 1065 tolas or at his option to sell sterling for immediate delivery in London at an equivalent rate (Section 5 of Act IV of 1927). The expression "equivalent rate" meant, that sterling had to be sold at such a price at which if the purchaser of sterling bought gold in London and shipped it to Bombay, the cost landed in Bombay would have been equal to Rs. 21.3. 10. per tola, having provided for packing, freight, insurance and interest on gold so imported.

This system, as mentioned above, would have been a gold bullion standard if the Controller of Currency would have in practice sold bars in India. In fact, however, the Controller has never sold gold bars but, based on his option

given by the Act, he sold sterling at the "equivalent rate" and accordingly in practice the Indian currency system was on the gold exchange standard from 1-4-27 up to 21-9-1931.

The actual currency in circulation consisted of paper currency notes and silver rupees which were thus exchangeable in fact into sterling at the rate of 1sh. 6d. The actual rate of exchange fluctuated naturally between the gold points, *i.e.*, between 1sh. 5-49/64d. and 1sh. 6-3/16d.

The rupee coin is a token coin for,—as well known—its intrinsic silver contents are below its face value. At present the intrinsic silver value of the rupee is about eight annas. In other words a rupee buys about the double of the quantity of its silver contents on the silver market in form of silver bullion. The rupee is in fact a note printed on silver and from the point of view of monetary theory equal to a somewhat expensive paper currency. In the mind of the public, however, based on historical traditions coming down from the time of the silver standard prior to 1893, it is regarded by the population of this country as the standard coin of India. From the view point of the masses if the convertibility of the paper notes into silver rupees is secured the system functions correctly. The man on the street can neither be expected to understand the problems of external convertibility, nor is he in any way interested in such questions. The laymanly, but in practice very important, attitude of the masses has always to be considered in connection with currency legislation in India.

The currency notes were issued against gold, silver rupees, silver half rupees, Government securities and internal bills of exchange.

(*b*). *Emergency currency.*

Internal bills of exchange (hundis) formed the basis of "emergency currency". This institution was introduced by section 20 of Act X of 1923 and was meant to help to

tide over the monetary stringency during the busy season. The emergency currency thus introduced was supposed to be a modest beginning of the discounting system, which is the chief basis of the reforms to be introduced by the present Bill. In view of this importance a few further details will be necessary.

It is a wellknown fact that in connection with the marketing of crops the monetary conditions show great fluctuations in India. The easy monetary conditions of the slack season are unpleasantly contrasted with the monetary stringency of the busy season, when huge amounts are required to finance the marketing of crops. The object of emergency currency was to find a further basis of expansion of currency during the period when the volume of business greatly expands. A solution was undertaken by section 20 of Act X of 1923 authorising the Controller of Currency to issue currency notes not exceeding five crores of rupees* against bills of exchange maturing within 90 days. These notes were issued in addition to notes against which the reserve prescribed by law was held.

The success of this new experiment was rather limited and in view of the fact that the issue of bank notes under the proposed Reserve Bank Act will be partly based on the rediscounting of internal bills of exchange, it is of utmost importance to analyse the conditions under which the "emergency currency" proved to be a rather limited success.

Quite apart from this new institution of emergency currency, the Indian money market showed a marked tendency of a steady decrease of available internal bills of exchange and a steady growth of the cash credit system during the last two decades. The full significance of this position will be discussed in all details in the next chapter and now it seems to be sufficient to mention, that the chief cause

*The limit was raised to 12 crores of rupees by section 4 of Act XXXVI of 1923.

of this limited success was firstly the fact that emergency currency was issued only on the condition that the rate of the Imperial Bank, which is regarded in India as "the bankrate" had to be raised to an exorbitant level, and secondly because the rediscounting system according to which banks and bankers rediscount their Bills with the Central Bank, was not practised. On the contrary, banks regarded it as a sign of weakness to rediscount bills with the Imperial Bank. Under such circumstances no wonder that the experiment with the new institution of emergency currency did not prove to be a great success, for it is a generally acknowledged truth that if there is an intention to create bills and expand credit, the bankrate has to be lowered. In India just the opposite has been tried as what is accepted central banking practice and the result was nothing less than to be expected. And if even such a rise in the bankrate would not have been the preliminary condition of the issue of emergency currency, from where would have such bills emanated if there were no proper channels through which, as in other countries, bills gradually flow for rediscount to the central institution.

(*c*). *The structure of the currency system on the gold standard.*

The actual structure of the currency position based on Act IV of 1927 and its precedents can now be described.

The assets against which the notes were issued, were held in the Paper Currency Reserve, which had two compartments. The *metallic reserve* consisted of gold, rupee coin and silver bullion and had to be at least equal to 50% of the total of notes in circulation except the, maximum, 12 crores of rupees, issued as emergency currency (sub section 7 of section 18, Act X of 1923). The *security reserve* consisted of Government of India rupee securities and was limited to 100 crores of rupees (section 2 of Act X of 1925)

excluding the bills of exchange held as security against the emergency currency.

These rules reveal the interesting fact that the fiduciary issue in India is a combination of the fixed fiduciary issue with the proportionate fiduciary system.

The rule that the metallic reserve may not be less than half of the amount of the notes in circulation (except the emergency currency), is based on the principle of the proportionate system, whereas the limitation of the security reserves, both as regards Government securities, as well as currency issued against bills of exchange points to the fixed fiduciary system.

An example will show how this system actually appears in practice taking the highest limits of the fiduciary issue reached.

Reserves.		Note issue.
1. Metallic reserve	Rs. 100 crores	Rs. 212 crores
2. Government securities	,, 100 ,,	
3. Bills of exchange held against emergency currency ..	,, 12 ,,	
Total	Rs. 212 crores	Rs. 212 crores.

If and when, as in the above example the limits of fiduciary issue against Government securities and bills of exchange is reached, the system works as the fixed fiduciary system and further currency can only be issued against gold, respectively sterling (when off the gold standard). As long as on the other hand the upper limit of the security reserves is not reached the system works as the proportionate system, *i.e.*, against every unit of currency issued on the security of gold (or sterling now-a-days) another unit can be issued on the security of gilt-edge or commercial paper.

(*d*). *The Gold Standard Reserve.*

To complete the picture mention has to be made of the Gold Standard Reserve. The Paper Currency Reserve serves to maintain the internal convertibility of the paper notes and silver rupees. The external convertibility and the stabilisation of the foreign rate of exchange of the rupee is secured by the existence of the Gold Standard Reserve, which was accumulated from the profits of the rupee coinage. The Gold Standard Reserve consists of sterling, sterling securities and gold.

(*e*). *The abandonment of the gold standard.*

The changeover on 21-9-31 from the gold standard to a sterling exchange standard made no great difference. The rupee was delinked from gold by ordinance No. VI of 1931 (dated 21.9.31). This First Ordinance was repealed by Ordinance No. VII of 1931 (dated 24.9.1931) introducing certain exchange restrictions which however did not prove to be necessary and as a consequence this second ordinance was repealed by ordinance No. VI of 1932 (dated 30-1-33).

At present Act IV of 1927 is unrepealed and unamended on the Statute Book and India is *by law still on the gold standard.* In fact, by *executive action* the rupee is delinked from gold and linked to paper-sterling at the rate of 1sh. 6d. and is in practice fluctuating between 1sh. 5¾d. and 1sh. 6-3/16d. as regulated by executive action of the Controller of the Currency.

(*f*). *The chief features of the present system.*

Finally the chief features of the existing system have to be outlined so as to prepare the basis for a comparison with the proposed new system in the Bill.

It will be convenient to take the actual position into consideration. On the 31st August 1933 the following

abstract of Accounts of the Currency Department was issued :—

In lakhs of rupees.

Reserves.		Notes in circulation.
Silver coin ..	95,44	1,79,76
Gold bullion ..	29,31	
Silver „ ..	9,96	
—Metallic Reserve	134,71	
Government securities at purchase price	45,03	
Total	179,74*	1,79,76

The Gold Standard Reserve at the same time consisted of :—

Cash at Bank of England ..	.. £	2,996
British Treasury Bills ..	.. „	16,523,162
Other British and Dominion Government securities ..	.. „	12,161,508
Gold in England ..	.. „	2,152,334
In India	.. „	9,160,000
Total	.. £	40,000,000

In order to bring about a clear position first of all it is necessary to amalgamate on paper these two reserves.

*The difference of 2 lakhs of rupees is accounted for by neglecting the sums less than one lakh of rupee in each item.

In lakhs of rupees.

1. Metallic and sterling reserves.		Notes in circulation.
Silver coin	95,44	1,79,76
Silver bullion ..	9,96	
	105,40	
Gold bullion ..	44,35	
Sterling and sterling securities	38,53	
	82,88	
2. Securities reserve		
Government of India rupee securities ..	45,03	
Total ..	2,33,31	1,79,76

Taking a practical view it is correct to say that the fiduciary issue is only based on rupee securities, for silver rupees and silver bullion are held and considered in India as a metalic reserve for the sake of internal convertibility. Bearing this in mind it appears that the combined reserves show a metallic reserve of :—

Rs. 188,28 lakhs as compared with a note issue of 1,79,76 lakhs.

In other words the metallic reserve is in fact, more than 100% of the note issue.

This calculation supplies the facts to a real understanding of the present position and gives also the strongest support to the desire of the establishment of a Reserve Bank in India, being the only way to bring about sounder economic conditions.

(g). *Characteristics of the present system.*

The present system as clearly proved by the above calculations is wasteful and ineffective. Wasteful for it includes enormous metallic reserves far above the actual requirements which bring no interest and ineffective, because all these huge reserves do not enable the present system to expand currency in order to supply the country with sound credit.

It is true that the present system allows, according to law, for an enormous expansion of credit against the purchase of gold, silver, sterling and government securities. But such an expansion would be of very little use for productive purposes as it would only swell the unplaceable amounts in the money centres. It deserves notice that according to acts at present in force, currency could be expanded by not less than Rs. 54,97 lakhs against the purchase of marketable Government rupee securities, the limit of which is fixed at Rs. 100 crores, according to Section 2 of Act X of 1925. The position would then be, leaving naturally the Gold Standard Reserve out of consideration :—

Lakhs of rupees.

Assets.		Notes in circulation.
Metallic reserves	134,71	179,76
Government securities	100,00	54,97
	234,71	234,73

And even under such circumstances the metallic ratio would be well over 50%, which is the minimum laid down by the law in force at present.

§ 2. *The currency and exchange system as proposed in the bill.*

The next step is to analyse the proposed reforms as laid down in the Bill.

(*a*). *The rules regarding the composition of the reserves.*

In Chapter IV, §2 of Part II the clauses of the Bill as regards reserves (assets of the Issue Department) have been described. Now these rules will have to be summed up, the system inherent analysed and the possible working visualised. Some repetition of rules, which have been already described in Chapter IV, §2 of Part II is unavoidable before demonstrating the new system.

The reserves will consist under the proposed Act of the following assets :—

(1) External reserves :—
- (*a*) Gold coin,
- (*b*) Gold bullion,
- (*c*) Sterling, and
- (*d*) Sterling securities.

(2) Internal reserves :-
- (*a*) Rupee coin,
- (*b*) Government of India rupee securities,
- (*c*) Bills of exchange, and
- (*d*) Promissory notes.

I. The *first* rule to be noted is, that the external assets must form at least 40% of the total assets. (33(2))

II. *Secondly* gold coin and gold bullion may not be less than Rs. 35 crores valued at Rs. 21.3. 10. per tola of fine gold, in fact about 36% higher or 12½ crores of rupees more, valued at the present market rate. (33(2))

The combined result of these two rules is, that the actual minimum of sterling and sterling securities to be held in the reserves have to be not less, than 40% of the total assets minus at least 35 crores or more which amount has to be deducted on account of the compulsory gold reserves to be held. Considering this proposition it may be felt, that if for whatsoever reasons the note issue would be contracted, the 35 crores of rupees gold to be compulsorily

held would occupy an unduly high proportion of the assets, which bears no interest and can primarily not be used as an external asset. In such a case there would be either a too strong reduction of commercial paper or there would be less sterling in the assets. Both of these eventualities are rather unpleasant. The reduction of the Government of India securities held at present would scarcely be possible in the near future, being nearly all *ad hocs* (created securities). Seen in this light one wonders whether not the suggestion of Sir Campbell Rhodes is the most reasonable of all, who proposed according to a footnote appearing on page 6 of the Report of the Committee on Indian Reserve Bank Legislation, that no minimum gold reserve should be prescribed but complete freedom should be left to the Central Board in the matter of gold reserves.

III. The *third* rule lays down that the Government of India rupee securities shall not exceed fifty crores of rupees or one fourth of the total assets, whichever is less (Para 2 of sub-clause (3) of clause 33).

IV. The *fourth* rule, which relates to the period of transition only, when the assets will be transferred from the Government of India to the Reserve Bank, lays down, that the external reserves at that time may not be less than 50% of the total assets (Para 2 of clause 35) and finally,

V. the *fifth*, also provisional rule for the period of transition prescribes that the amount of rupee coin to be transferred from the Government of India to the Reserve Bank shall not exceed fifty crores of rupees. (Para 2 of clause 35)

(*b*). *How will the new system appear in practice.*

In order to frame an idea of the actual situation of the proposed reserve system the following table may give a rough idea expressed partly in terms of per cents.

Assets.	Notes in circulation.
I. External assets at least 40%	100%
(*a*) Gold at least 35 crores of rupees.	
(*b*) Sterling at least 40% minus 35 crores or the actual higher figure of gold holding.	
II. Internal reserves maximum 60%	
(*a*) Rupee coin about 50 crores of rupees.	
(*b*) Government of India rupee securities maximum 25%. or 50 crores of rupees whichever is less.	
(*c*) Commercial paper maximum 60% minus rupee securities and rupee coin.	

(*c*). *The possible role of rediscounting commercial paper.*

The most important point to be considered in connection with the proposed rediscounting of commercial paper is the likely position of this asset. ***First*** of all it may be noted that the external assets will usually be more than 40% in order to have a margin to fall back upon in lean days. In practice there will be about 50% or even more in days of favourable external balances of trade and payments. *Secondly* rupee coins may and possibly will be somewhat higher than 50 crores of rupees, as the general acceptance of paper notes is gradually extending up country. The holding of Government of India rupee securities could theoretically stand at a much lower figure, than the maximum but in practice it may be assumed, that the holding of such securities will be near the maximum in the near future. Perhaps the most convenient way of framing a practical idea about the initial position would be to visualise how matters would stand if the Reserve Bank of India would

have been started on 1-9-33. For this purpose the position of the actual reserves held by the Government of India can be utilised. Taking the figures from the combined reserves as shown on page 96 the assets of the new Reserve Bank would have been as under :—

Assets of the Issue Department.			Notes in circulation.
	Lakhs of rupees.		
I. External reserves ..			1,79,76
Gold	44,35		
Sterling	45,65*		
	90,00		
II. Internal reserves			
Government of India rupee securities ..	40,00**		
Rupee coin	50,00		
Total ..	179,76		179,76

The above calculation does not reveal a very rosy chance for a margin of rediscounting of commercial paper. The percentage of external reserves, it is true, can be reduced below 50%, which is prescribed only for the time of transfer, but in practice it will be advisable to remain on this somewhat higher margin.

This general survey drives necessarily to the conclusion that the Government of India rupee securities stand in the way of securing a margin for the rediscount of commercial paper.

Two points deserve attention in this connection. *Firstly*, that the rediscount of commercial paper could take place

*The present shortage of sterling assets—it is assumed—would have been replenished partly through the sale of silver and partly by sterling purchased by Government with the help of Treasury balances or borrowing.

**It is assumed that *ad hocs* will be reduced with help of Treasury balances or borrowing.

at the beginning with the help of the assets of the Banking Department. Apart from the capital of five crores, the compulsory deposits of the scheduled banks and the public deposits will furnish the Reserve Bank with considerable assets, which may be estimated taking again the position on 31-8-33—at Rs. 18 crores.

Secondly, some method or other will have to be found in order to reduce the *ad hoc* securities. It may perhaps be feasible to float a new Loan which will be entirely taken up by the new Reserve Bank in exchange for the *ad hocs*. By this way the presently unsaleable *ad hocs* could be converted into marketable securities and gradually sold off. From the point of view of Government such a wholesale conversion of *ad hocs* into long term loans may be most convenient at the prevailing low rates of interest. According to sub-clause (3) of clause 33 Government of India rupee securities of any *maturity* can be held within the assets, and therefore a most convenient, fairly long term Loan could be floated.

The result of these investigations proves that apart from the balances at the disposal of the Banking Department under present conditions there will be little chance to rediscount bills or other commercial paper in the Issue Department at the commencement.

There are only three possibilities to rediscount gradually commercial paper, in the Issue Department. The *first* possibility would be an increase of the external assets, *i.e.*, sterling, for gold is not likely to reach the Issue Department at the present market rate. An increase of the sterling holdings according to the rules of the proportionate fiduciary issue allows for a further expansion of currency against fiduciary issue in the proportion of 40 to 60. If for instance sterling of the equivalent of one lakh of rupees flows into the reserves, commercial paper worth one and a half lakh of rupees may be rediscounted, or Government of

India rupee securities purchased, as long as the upper limit of the Government rupee securities is not reached.

It may be, however considered, that such an increase of the sterling assets can only take place in case the trade balance strongly improves. Taking facts as they are, there is not much chance to secure possibilities by this method.

Secondly the reduction of Government paper held in the assets by the above indicated method and *thirdly* by reducing the proportion of the external assets from 40% to say 25% as recommended by the Report of the Gold Delegation or by abolishing a fixed proportion altogether as advocated by Sir Henry Strakosch and his two collegues and to leave it entirely to the judgment of the Central Board to keep the necessary amounts of external assets according to the actual conditions and possible requirements. A consequence of such a radical change would naturally be that Sir Cambell Rhodes' suggestion as regards the gold reserve would have also to be adopted, for it would be impossible to keep a much lower proportion of external assets and maintain at the same time a lower limit of 35 crores of rupees for the gold reserves.

If the present note circulation of about 180 crores of rupees is taken as the basis of calculation, 45 crores would represent 25% and if at the same time a lower limit of compulsory gold holding of 35 crores of rupees would be maintained, only 10 crores would represent the compulsory minimum holding of sterling assets.

Pondering over these possibilities it appears that an increase of sterling holdings is a possibility which is outside the scope of voluntary regulation as it depends on the improvement of the balance of trade. A decrease of Government rupee securities, if a conversion of *ad hocs* into marketable securities as advanced above, is carried out is firstly a point to be considered by Government—so far as the conversion is concerned—and secondly it will be a matter

of the policy of the Bank to what extent Government securities may be sold off and replaced by commercial paper. Whether a reduction of the legal minimum of external assets should be the right method to follow is a matter for consideration for the members of the Legislature and the Governor General. Such a decision can only be made if the importance of the rediscounting of commercial paper is fully analysed and appreciated. It will be the object of the next chapter to give all details and arguments in this respect.

(*d*). *The elasticity of the note issue.*

An important test to every currency system is, whether it provides for an elastic note issue or not.

A word of explanation may be necessary in order to elucidate the meaning of "elasticity of note issue".

The term as generally used is somewhat incorrect, for, in fact it is not the note issue, that has to show elasticity but the rules laid down in the charters of Reserve Banks have to be so framed, as to give such devices into the hands of the management, as will allow for an elastic expansion or contraction of the currency if various circumstances either as regards the composition of the reserves or the economic conditions change suddenly.

Analysing the present system as well as the proposed system it may be stated that both the systems are inelastic from a certain point of view. It deserves however, notice, that the present system is more elastic as compared with the proposed new system in the commencement.

Under the present system, as explained on page 97 there is a wide margin of expansion possible, apart from an increase of the external assets, against marketable securities and even against the purchase of silver under the law actually in force. Apart from the purchase of silver, which could possibly not be considered seriously to-day, though

legally permissible, an expansion against Government of India marketable securities is possible to the extent of 54,97 lakhs of rupees taking the position on 31-8-1933 into consideration, based on section 2 of Act II of 1925. Such an expansion, however, would not be of much use in stimulating trade and commerce, for it would only swell the unplaceable liquid cash holdings of the large cities, as mentioned above, and would most likely not reach such channels through which production and consumption could be stimulated.

To issue a further 12 crores of rupees under the emergency currency section is also not possible as hundis, internal bills of exchange, are not forthcoming.

A laudable executive action of the Finance Department has to be mentioned, in this connection, contained in a Press Communique of that Department.* It deserves notice that according to this newly introduced possibility a rise of the bankrate is not required as was in case of the issue of emergency currency.

Before entering into a detailed criticism of the propositions of the Bill it has to be emphasised that an expansion similar to that instituted by the Press Communique is not possible under the Bill if commercial paper is not forthcoming, for the simple reason that the upper limit of the holding of Government of India rupee securities has been

*Press Communique. Dated, the 15th January 1932. "Hitherto the seasonal expansion of the currency has been effected by loans to the Imperial Bank of India from the currency against the deposit of inland Bills of exchange in the Paper Currency Reserve in accordance with section 20 of the Indian Paper Currency Act. As the amount of eligible Bills of Exchange held by the Bank at present is insufficient to meet the seasonal demand for currency, the Government of India have arranged to make such further loans from the currency as may be necessary against the deposit in the Paper Currency Reserve of Government of India Rupee securities, purchased temporarily from the Bank.

When the seasonal demand for the currency decreases, the Bank will repay these loans by re-purchasing the rupee Securities on terms which will have the effect of making the rates of interest on loans against the rupee securities the same as those on loans against Bills of exchange. The note-issue will then be controlled automatically as the loans are repaid.

Expansion of Rs. 2.5 crores against rupee securities has been effected in this way on January 15th 1932."

reduced from 100 crores of rupees to 50 crores of rupees or a maximum of 25% of the total assets, whichever amount is less (clause 33 (3)). Taking the actual note circulation on 31-8-33 at roughly 180 crores of rupees the holdings of Government paper valued at 45 crores represent 25% of the assets, *i.e.*, the upper limit. In other words if the Reserve Bank would have been started on that day a further expansion against Government Paper would not have been permissible and also not against commercial paper. A rediscount of commercial paper—if forthcoming at all—could take place to the detriment of the sterling holdings only, which if lowered near to the minimum limit could bring the entire mechanism into a dangerous position in these days of unfavourable balance of trade.

This examination proves that at the outset no expansion would be possible at all and it may be generally agreed, that it would be a most unpleasant situation if the Reserve Bank of India would right at the outset, have to request the Governor General in Council for a suspension of the assets' requirements as provided for in clause 37 of the Bill.

Passing a final judgment on the principles of the Bill as proposed regarding the assets viewed from the angle of elasticity it may be unhesitatingly stated, that these propositions would create *at the beginning* a system much less elastic than the present system and as has been proved with the help of the above figures in case of monetary stringency it would not be able to satisfy the needs of legitimate trade at all and even a suspension of the assets requirements would be necessary.

In order to achieve the necessary elasticity and in continuation of the possibilities as outlined above the following changes in the Bill may be recommended :—

(1). The percentage of the external assets may be reduced from 40% either to a lower figure or abolished altogether and be maintained according to the judgment

of the management as recommended by Sir Henry Strakosch in the Note of Dissent appended to the Report of the Gold Delegation of the League of Nations.

(2). The upper limit of Government of India rupee securities holdings should remain unchanged at the present figure of 100 crores of rupees, so that if commercial paper is not forthcoming currency could be expanded against gilt-edge which could be taken from the scheduled banks in the form as instituted by the above quoted Press Communique. This new system has namely the advantage that the currency created ageinst the security of gilt-edge reaches the producers as the banks can create new cash credits with the help of such newly issued currency. The argument may be advanced against this recommendation that according to clause 17 (4) (*e*) promissory notes of scheduled banks or provincial co-operative banks drawn against cash credits and supported by documents evidencing the title to goods may be accepted by the Reserve Bank as security against advances and although such promissory notes cannot be held as assets against the note issue (clause 33 (3)), it may be possible to accept such securities in the Banking Department and issue fresh currency against eligible securities handed over to the Issue Department from the Assets held in the Banking Department.

In reply to this possible argument it may be pointed out that the Banks at the beginning will be probably rather reluctant to come forward with such promissory notes drawn against cash credits, whereas it is much more likely that they will approach the Reserve Bank asking for loans against gilt-edge.

This recommendation to maintain the present upper limit of 100 crores of rupees for the holding of giltedge amongst the assets can however, only be effective in practice if the external asset ratio is also lowered at the same time as recommended under (1) above, as

otherwise an expansion against gilt-edge can only take place if there is an increase in the sterling holdings, which is not likely in the near future.

The elasticity of the proposed new currency system as regards contraction is also not satisfactory. Under the present system currency can be contracted against the sale of silver or withdrawal of silver which forms a rather high proportion, against sterling securities and also against *ad hocs* if the Government choosed to repay part of the created securities and lastly against the repayment of internal bills of exchange if there were such holdings against emergency currency. The new method as introduced in the Press Communique dated 15-1-1932 also provided for an automatic contraction when the loans were repaid by the Imperial Bank.

A glance at the new proposals, on the other hand reveals the unpleasant fact, that contraction under present circumstances will not be possible apart from selling external assets, a procedure which may not be desirable as the sole method of contraction. The sale of silver is prohibited by the Bill under clause 38. Government securities as long as they are chiefly *ad hocs* cannot be sold. It is true that some contraction will be possible by selling assets of the Banking Department, but it has to be considered that such sales are naturally limited to the holdings of that Department.

It is true that contraction will be possible if currency has been expanded against external assets (sterling) and commercial paper and accordingly in theory the proposals of the Bill cannot be criticised as regards elasticity, but in practice the actual situation has to be examined and in the near future there is very little likelihood of acquiring considerable external assets and rediscounting commercial paper. It has also to be noted that even when commercial paper will be forthcoming through the scheduled banks,

it will not be possible to sell such paper in the absence of a bill market as will be explained in the next chapter.

Elasticity as regards contraction can only take place if the currency can be first expanded, based on the recommendations put forward above. The same elasticity of contraction as exists under the present system is inherently missing from the proposed system under the present circumstances.

The next chapter will attempt to elucidate these points from the angle of the credit problem.

CHAPTER II.

THE CREDIT PROBLEM.

§ 1. *The actual problem in India.*

The proposed Reserve Bank of India will be in general charge of the currency and credit system of the country. The currency questions have been discussed in Chapter I and it remains now to analyse the credit system and the proposals of the Bill.

It is generally known, that whereas in other countries currency and credit are handled and controlled centrally by Reserve Banks, in India these two very important factors of the economic structure of the country, are in two different hands at present. The Controller of the Currency is in supreme charge of matters relating to currency and exchange, in the name of the Governor General in Council, and to a certain extent the Imperial Bank of India is at the top of the credit structure, if the word credit structure can be applied at all to a situation, where in fact no credit system can be traced.

It is, on the other hand, not quite correct to say, as usually done, that one of the most prominent disadvantages of the present situation consists in the fact that credit and currency are not controlled by one and the same authority. This assertion is not quite correct for the simple reason, that currency and credit are managed in fact in collaboration and as a result of mutual discussions of the Controller of Currency and the Managing Governors of the Imperial Bank. The Controller of Currency is one of the Governors of the Imperial Bank and it would be rather absurd to believe that these authorities act without co-

operation and that either of these authorities could initiate and carry through a policy, which would be exactly contrary to the actions of the other party.

The basic difficulty of the present situation does not lie in this supposed dual control of currency and credit, but is the outcome of the fact that credit in this country cannot be kept fully under control for there is no such system and institution in existence, as could make a necessary control of credit possible. It would be wholly unjust to blame the Imperial Bank for this deficiency. The Imperial Bank of India Act 1920 gave birth to a hybrid institution at a time when the establishment of a Reserve Bank was not possible on account of the unsettled conditions of those days just after the war. The Government of India considered the establishment of a Reserve Bank in pre-war days and to consider this problem was one of the tasks of the Chamberlain Commission. No lesser authority than Mr. J. M. Keynes was asked to submit a special Report on the subject, but no action on the Report was possible, because of the advent of the war.

Sir Basil Blackett, the reorganiser of the currency system, attempted to establish a Reserve Bank when the postwar chaos gradually settled down and based on the recommendations of the Hilton Young Commission, introduced his well known Bill in the Legislative Assembly. The fate of the Reserve Bank Bills of 1927 and 28 are too well known, to require repetition here.

It is in the realm of credit, where the absence of a Reserve Bank is badly felt. Should the present Bill be enacted and be able to give India the much needed credit reforms and facilities, than the Act will become a valuable asset of the country. It is necessary to consider therefore whether, the Bill as introduced contains the foundations of a suitable mechanism. However it should be repeated that the best Act remains on paper if the future management

of the Bank will not be capable of properly discharging this most intricate task. It is necessary also to examine what method could be employed to bring about a successful working of that credit system, the foundations of which are laid down in the Bill.

It is generally recognised, that the basic problem of a better credit system in India depends on whether the western system of discounting bills and the still more efficient system of acceptance credits can be introduced and developed in this country.

The actual position is rather peculiar and also unfortunate. It is well known that not more than two decades ago there was a considerable business in hundis in India, *i.e.*, an indigenous market of internal bills, partly commercial and partly financial. It is further well known that this market practically disappeared and as mentioned above not even 12 crores of eligible hundis were available by the wide spread organisation of the Imperial Bank to obtain "emergency currency". It may be interesting from the point of view of economic research to find out why hundis have disappeared and been replaced by cash credits, but our present object is to find solutions for a better future.

It is generally agreed that the introducion of a system for the discounting of bills and the opening of acceptance credits on a large scale is the only solution of the credit problem of India. This view has been expressed before the war by Mr. J. M. Keynes in his "Memorandum on the establishment of a State Bank in India", appended to the Chamberlain Report in 1914.*

The actual position of the problem was very clearly and most emphatically expressed by Sir Osborne Smith in his oral evidence to the Central Banking Enquiry Committee.

*"The creation of a rediscount market would render most vital assistance. Indeed I am most doubtful how far it is possible for them (the banks) to develop on really sound lines without it. Memorandum on etc. Chapter V page 207. Reports of Currency Commissions, 1928.

Sir Osborne expressed the opinion that given proper facilities and assuming that the heavy stamp duty will be lowered, and that the indigenous bankers will be co-ordinated to the discounting system under the Reserve Bank, *i.e.* if all these important conditions will be fulfilled there is a great likelihood that the discounting of bills will go ahead. One sentence of Sir Osborne's statement deserves, however, special attention :—

"I do not make out the position hopeless at all. If it were so, the Reserve Bank would not function at all."

(Central Banking Enquiry Committee, Volume III Oral Evidence, page 1113).

It is of great importance to note the opinion of an authority of Sir Osborne's standing in this respect.

The view has been however widely expressed, that as there are no bills in the market at present, it will not be possible to create an effective discount system. In order to show the way for a possible evolution, an attempt will now be made to analyse the possibilities of the creation of a sound discounting system.

§ 2. *The discounting of bills.*

It is felt that the problems connected with the discounting of bills is not quite understood in this country, for this system has never actually worked here.

It seems to be necessary therefore to start with the explanation of this system *in vogue* in Western countries.

(*a*). *Commercial bills.*

Clear distinction will have to be made between *commercial* and *financial bills* on the one hand and between *bonafide* and *non bonafide commercial bills* on the other hand. The question of acceptance credit will be discussed below.

The typical instance of the creation of a bonafide commercial bill is the case of a manufacturer, say a cotton mill, selling goods on three months credit to a wholesale dealer and making the acceptance of a draft a preliminary condition of granting credit. When the goods are handed over to the wholesale dealer he has to accept a draft drawn on him by the mill at, say, ninety days sight. This procedure is the creation of an inland trade or commercial bill, drawn and payable in India and arising out of a bonafide trade or commercial transaction.

It is well to emphasise that such bills are not *necessarily* connected with documents such as a bill of lading or a railway receipt. If the wholesale dealer is situated in the same town as the manufacturer, the only document which can emerge out of such a transaction is a *signed challan*, signed usually by a storekeeper. If goods are sent up-country a railway receipt or a bill of lading will also be available.

With the exception of Great Britain such bills are the real basis of the fiduciary issue of bank notes in Western countries, for this type of bills are rightly regarded as self-liquidating assets.

The discounting of bills of exchange takes place when the manufacturer, who holds a good number of such bills, is in need of cash and approaches his bank with the request to discount his bills. If the manufacturer is of a good standing and if the acceptor of the bill is also known to be sound the bank will gladly discount such a bill bearing two good signatures, if the bank knows that the Reserve Bank is willing in turn to rediscount the bill. The bank will discount the bill by deducting the interest for the period in question and will credit the balance to the manufacturer. When the bank will in turn desire to exchange part of its bills held, into cash, it will approach the Reserve Bank and request it to rediscount these bills. In that case the

signature of the bank will be the third good signature, on the security of which the Reserve Bank may issue fresh currency. A rediscounting of bills does not necessarily involve a fresh note issue, for the Reserve Bank can rediscount bills from the assets available in the Banking Department.

The creation of inland commercial bills can also take place between a wholesale dealer and a retail dealer, between a retail dealer and a regular customer, or between an importer and the dealers, to whom imported goods are sold, also if a wholesale dealer sells raw material to the manufacturer. The chief points are *firstly* that such self liquidating commercial bills be created when goods are sold in their way from raw material to consumer and *secondly* the condition that the seller is willing to grant credit to the buyer. Now as regards the Indian credit structure, the commercial process of all manufactured goods whether made in this country or whether imported could be financed with the help of such bills.

(*b*). *Agricultural bills.*

On the other hand it is a fact that the greatest part of Indian production and business consists of agricultural produce and that there is not the same chance to create bills in that domain of the economic life. When crops are marketed they are sent on their way to the consumer by small merchants through larger ones and therefore it is evident that in practice such smaller merchants are not in a position to grant credit to the larger ones. On the contrary the bigger merchants often advance money to the smaller traders to buy agricultural produce up country for them. For this purpose a certain type of acceptance credit is advocated below, for in this case the larger merchant requires credit, whereas in the typical case of creation of commercial bills, the manufacturer, or the wholesale dealer grants credit to the smaller dealer.

As regards agricultural credit and the creation of an agricultural bill of six months running it may be noted that such loans will be chiefly granted by co-operative societies to the agriculturists, as advances against their crops, on the security of bills of exchange, maturing within six months, as provided for in para (*b*) of sub-clause (2) of clause 17 of the Reserve Bank Bill. These are bills created for the purpose of financing seasonal agricultural operations. The dealers who purchase the agricultural products may be financed with the help of promissory notes given by them to the local banks or to co-operative institutions.

(*c*). *Bonafide and non-bonafide commercial bills.*

A difference has to be made between commercial and financial bills.

Commercial bills are the above described bills the origin of which is truly connected with commercial transactions, sale and purchase of commodities or growing agricultural produce and manufacturing of goods. Bills which arise out of such transactions are bonafide commercial bills.

A financial or accommodation bill, on the other hand, is a bill drawn by one person and accepted by another person who are anxious to obtain credit from a bank or a banker for whatsoever purpose purely on the credit of their signature *i.e.*, on their personal standing and worth. There is no commercial transaction behind such a method of obtaining credit, and the amounts so secured may be used for any purpose and the purpose itself is of no importance.

Unfortunately there is a good deal of confusion as regards bonafide commercial bills and accomodation bills. It is generally believed that an accommodation bill is a non-bonafide commercial bill. To simplify matters it will be convenient to describe the case of a typical non-bonafide commercial bill.

It may be assumed that a bank has a manufacturer as its regular customer, who in the course of his ordinary day to day business discounts bonafide commercial bills, as described above, with that bank. The names of the acceptors are also well known to the bank, and are known to be the regular buyers of the products of that manufacturer.

It may happen, that such a manufacturer and one or more of his regular buyers who are on intimate terms, desire to obtain more credit than possible on the basis of bills drawn against goods actually sold. In other words they would like to create bills in order to obtain more credit than they can get with the help of discounting their usual bonafide commercial bills, which arise from their actual commercial transactions. For this purpose the manufacturer draws on one of his usual buyers, with its consent, and sends the bill of exchange so created to his bank for discounting. Under such conditions the bank cannot possibly find out whether it is a bonafide commercial bill or not, as the parties are known to maintain regular commercial connections with each other. If later on such a bill is presented to the Reserve Bank for rediscounting, it will also be accepted as a bonafide commercial bill, as such bills bearing the same signature have been several times rediscounted previously by the Reserve Bank and payment has been regularly obtained on the due date.

It has to be stressed therefore that it is scarcely possible to detect whether such a bill is *bonafide* or *non-bonafide.*

This aspect has been clearly brought out before the Hilton Young Commission in connection with the oral evidence of Mr. Charles Nicoll, General Manager of the National Bank of India (questions No. 14,143 and 14,143A):—

Sir Henry Strakosch asked :—

"But if it (the Reserve Bank of India) had the right of note issue and if one of the conditions of note issue was

that apart from a certain percentage of gold it could put into its Issue Department local bills, would not that strengthen it ?"

Mr. Nicoll replied :—

"What sort of bills ? It is very difficult in India to discriminate between bills, which actually represent transactions in produce or commodities, and bills which are simply accommodation bills".

Sir Henry Strakosch :—

"But so it is in every other country".

Mr. Nicoll :—

"Not to the same extent in India—much more difficult in India".

Whether it would be more difficult to detect the difference between *a bonafide* and *a non-bonafide* bill in India or elsewhere may be doubted on the basis of the above explanation.

Summing up it may be stated that, there are bonafide and non-bonafide commercial bills and that *all* financial or accomodation bills are *bonafide* fianancial bills. A bill cannot be a non-bonafide financial bill, for the simple reason that a financial bill does *not pretend* to be *anything else* than what it really is, namely a method to obtain credit with the help of two or more good signatures for whatsoever purpose. A *non-bonafide* commercial bill on the other hand, pretends to appear to be something else than it really represents.

On the continent of Europe commercial bills are usually not accompanied by documents evidencing the commercial transactions against which the bill is drawn. In the U. S. A., on the other hand, it is understood, that documentary evidence is required according to the rules of the Federal Reserve System.

It may be considered, whether such documentary evi-

dence should be required in India or not. Such evidence is possible for signed challans, railway receipts and inland bills of lading would be available for this purpose.

§ 3. *How could the discounting of bills be encouraged in India?*

As there are no, or only very few bonafide commercial bills available in India and as on the other hand it is of great importance to extend credit facilities in this direction, it will be attempted now to point out such ways and means with the help of which the bill habit could be encouraged in India.

A Reserve Bank Act, as has been sufficiently stressed above is only a frame within the limitations of which the management can operate. As regards credit facilities ample provision has been made by the Bill to extend credit in every possible way.

The next step is now to outline what could the management of the Reserve Bank undertake so as to have bills gradually forthcoming in the near future, for it is perfectly clear that the fact by itself, that the Act will give every facility for rediscounting and that the Reserve Bank will be fully prepared to rediscount bills held by the member banks, provided the signatures are good, will not suffice to create bills.

Definite steps will have to be undertaken in order to change the credit structure of the country gradually, and this can be achieved by three distinct actions :—

(*a*) *First* of all by fixing a special low bank rate for discounting bills as compared with the rate at which the Reserve Bank is willing to make advances against securities.

(*b*) *Secondly* the banking structure of the country has to be so linked up, that the bills can flow from all possible sources to the Reserve Bank.

(c) *Thirdly* the present shyness of the banks will have to be overcome so that they shall feel it part of their ordinary business to rediscount bills with the Reserve Bank.*

(a) *A special discount rate.*

At present far the greatest part of credit is given an cash credit accounts in this country. A cash credit transaction does not,as a rule,create any negotiable instrument.** Furthermore a considerable part of loans and advances are made against the security of gilt-edge. All these credit facilities stand in the way of the creation of bills and as a consequence there is no other method to encourage the development of discounting and rediscounting but by fixing a lower rate for this special purpose leaving the usual higher rate for advances against securities.

This method seems to be the only possible way to induce the banks and their clients to create bills.

It was stated in evidence before the Central Banking Enquiry Committee that if bills are not forthcoming in sufficient quantities the management of the Bank should not be afraid to lower the discount rates even to such a low level which is unknown in the history of banking. If bills are not forthcoming as for instance during the last few years the discount rate may be lowered even below one per cent. It may go as low as one-half or even one-quarter of a per cent. if bills are not forthcoming at all.

It may be assumed that when there will be, for instance a difference of three to four per cent. between the advance rate and the discount rate, that banks and clients will take the advantage of cheap credit offered in the form of rediscounting Say the rate of the Reserve Bank for advances will be 4% and at the same time the discount rate

*That the present heavy stamp duty on bills will have to be lowered or abolished is generally accepted.

**The bill, however, provides even for sueh an instrument in para (e) of sub-clause (4) of clause 17, for a period of transition of five years.

only 1% or ½%. Even under such circumstances a lot of propaganda and informatory work will be necessary to create bills.

A most important consequence of this device of having a separate lower discount rate and a higher advance rate at the same time,* has however to be emphasised, for it has to lead to the suggestion, that clause 45 will have to be suitably amended.

In India at present the advance rate of the Imperial Bank of India has to be regarded as the *bankrate* and a great number of credit transactions are fixed at rates which bear a direct relation to *this* bank rate.

If the proposed Reserve Bank will have two rates, a higher advance rate and a lower discount rate, it will not be convenient during the first years to describe the bank rate as the minimum rate at which the Bank is prepared to rediscount bills of exchange or other commercial paper. If the above suggestion, which is one of the recommendations of the Central Banking Enquiry Committee, is adopted, a certain change in clause 45 of the Bill has to take place, stating that along with the rediscount rate an advance rate will also be published every time.

It has namely to be considered that if during the first period the method to encourage the rediscounting of bills with the help of a very low discount rate is adopted, it will be the more "normal" advance rate, which will be the basis of the average bank credit transactions just as to-day the advance rate of the Imperial Bank. It is strongly recommended therefore to insert such a provision into clause 45, for it would lead to peculiar consequences if, only the extremely low rediscount rate would be published and it would throw out of gear all those credit arrangements which are fixed to-day in proportion to the bank rate.

*This device was also recomended by the Central Banking Enquiry Committee see para 593 (1) on page 410 of the Majority Report.

In conclusion it may be mentioned that such an extremely low discount rate, which would be used to encourage the creation of bills at the beginning, will have no unpleasant economic consequences for it has to be borne in mind, that such a low rate will only be quoted when there are in fact no bills or only very few forthcoming. If bills will gradually come forward for rediscounting, the advance rate can be also gradually raised, but taking duly care that a margin shall always remain between advance rate and discount rate.

(*b*). *A systematical linking up of the banking system.*

In connection with the examination of the "emergency currency" experiment, it has been mentioned, that it was bound to be a failure because bills can only come forward if the bankrate is lowered and not raised and secondly if there are proper channels available through which the bills can flow into the Reserve Bank (or at present to the Imperial Bank) from all parts of the country.

It can not be contradicted that at present there is no banking system in India and that if the Reserve Bank will be successful in this respect, it can by that result alone do great benefit to the country. It is not necessary to describe the present unsystematical banking position. A glance at the system of other countries instead may prove more useful. The British system will not serve as a good example, for broadly speaking the amalgamation of hundreds of banks and banking firms has gone so far in that country that practically the entire commercial banking system consists of the *Big Five* and its thousands of branches.

Speaking in general, in most countries the banking system consist of a lot of smaller banks and bankers spread all over the country, intermingled also with branches of bigger banks. Then there are a number of medium sized banks and on top the big banks with their head offices usually

in the capital of the country. There are also in most countries bankers and private banking houses of medium and large size. The pyramid ends in the Reserve Bank which is the central or apex institution. In countries where the co-operative banking system is well developed the co-operative institutions form also in their totality such a pyramid which also ends in the Reserve Bank.

As regards the flow of credit there are certain layers as regards the directness of indirectness of connections to the Reserve Bank. Institutions of a certain size whether banks, bankers or co-operative institutions are in direct touch with the Reserve Bank. Smaller banking or co-operative bodies, on the other hand, go to bigger ones for rediscounting or other credit facilities, and are a sort of affiliated bodies in this respect. These bigger institutions, which obtain credit directly from the Reserve Bank on the basis of their recognised standing, are in intimate touch with a number of smaller institutions. They gradually find out their position and the highest credit margin that can be granted to them. Such a system is also helpful in distributing risks, based on the particular experience of the bigger institutions as regards their satellites.

The rate of interest charged by the largest institutions is also naturally lower than that charged by the smaller ones, but the type of clients is also of a different standing.

Such a system creates the channels not only for the even flow of credit from the Reserve Bank downwards to the smallest bodies of the banking structure, but it also provides for a proper selection of the negotiable instruments and other securities which form the basis of the fiduciary issue and which flow upwards to the Reserve Bank.

Reverting now to India one is inclined to feel that it should be the intention of the Reserve Bank to create

gradually such a pyramid system which would be extremely helpful to the Reserve Bank.

In the pre-war days when Mr. Keynes was attempting to frame the rules of a Central Institution for India, he felt that one of the main difficulties would be :—

".....to maintain in the day to day management of the Bank the high degree of decentralisation to which great importance is attached in the case of so large a country as India". (above-mentioned Memorandum, page 187).

It is submitted that it will be more or less practically impossible for the management of the proposed Reserve Bank to maintain a high degree of decentralisation as Mr. Keynes so correctly felt it. The only possible solution would be for the Reserve Bank to achieve this object to open a great number of branches all over the country. And that such a spreading of branches could neither be practicable nor profitable is evident.

The gradual introduction of the above proposed pyramid system may be a possible way out of this difficulty.

A glance at the second schedule attached to the Bill will reveal to all who know something about Indian Banking that it is anything but similar to the pyramid system. In fact, to be frank, it is exactly the opposite. It is unthinkable how could the Reserve Bank possibly be in direct touch with all these small institutions far away from its Branch offices.

Another serious defficiency of the Bill is the total absence of any provision as regards indigenous bankers. The labours of the Central and Provincial Banking Enquiry Committees, the evidences of the witnesses and the discussions with the foreign experts, seem to be all wasted in this respect in view of this silent attitude of the Bill so far as indigenous bankers are concerned. It is the unanimous recommendation of the Banking Committees that the in-

digenous bankers should be linked up to the Reserve Bank, and thereby provided with rediscount facilities from that institution.*

A glance at the list of scheduled banks, (Second Schedule) will give ample proof that it is correct to say that there are a considerable number of first class indigenous bankers of old standing and great reputation in this country, who are on a far higher level in every respect than many of the joint stock banks. The representatives of the Imperial Bank of India will be able to give expert evidence in this respect to the Joint Select Committee and will be able to prove that a large number of indigenous bankers are in a most cordial direct relationship with the Imperial Bank in every part of India and that many of them enjoy much more extensive credit facilities than some of the scheduled banks.

It is most seriously recommended that the Joint Select Committee should insert a clause as regards the direct linking up of the prominent members of the indigenous banking Community with the Reserve Bank on the lines of the recommendations of the Central Banking Enquiry Committee.**

(*c*). *How to overcome the shyness of banks as regards asking for rediscount facilities.*

The peculiar circumstances of India, the absence of a real central institution have brought about a rather unpleasant phenomenon which consists in the fact that banks are afraid to ask for accommodation from the Imperial Bank, for when such an event becomes public it may be rumoured, that that particular bank has asked for assistance and is probably not on a sound footing.

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*See para 139. page 107, Majority Report, Central Banking Enquiry Committee Volume I.

**See paras 137 to 146 of the Majority Report.

The oral evidence of Mr. Bowie, General Manager of the Allahabad Bank, before the Hilton Young Commission elucidates the position of the banks in this respect :—

Question No. 12263 (Sir Alexander Murray) :—

"I do not quite understand the reasons you give for your reluctance in approaching the Imperial Bank in the event of your requiring assistance. Fortunately you never required to approach the Imperial Bank for assistance, I take it ?—I would not say "fortunately". It was part of our policy not to do so."

Question No. 12264 :—

"As far as I know, it is the practice for banks generally in India to come to the Imperial Bank, and the advances given by the Imperial Bank to banks generally at times have reached about 10 crores of rupees. Why do you act differently from the other big banks in India in that respect ? Simply for the reason that in 1913 we got a lesson when a rumour to our discredit was about that we had asked for assistance from the Imperial Bank."

It is evident that if the Allahabad Bank has gathered such experiences that the smaller banks are bound to feel reluctant to approach the Imperial Bank for accomodation.

An examination of the present relationship of the banks with the Imperial Bank is entirely outside the scope of this book and accordingly only the consequences of the present situation and the possible remedies are to be examined.

Whatever the reason may be, it is a fact, that banks feel shy to-day to ask for accomodation from the Imperial Bank, and that such a situation has arisen, can only be explained and excused by stating that a commercial bank (*i.e.*, the Imperial Bank) cannot be a bankers bank at the same time.

The consequences of this unpleasant situation, however exist and are not easily to be remedied even under the new era of the Reserve Bank. A few points may be, however considered as regards such a policy on behalf of the future management of the Reserve Bank, as may gradually bring a solution, if much tact and personal leadership is exercised.

Before putting forward these suggestions a matter of principle has to be pointed out, that may be helpful in dealing with a situation which is possibly a consequence of the different methods adopted by the British Banking system as compared with the banking systems of other countries. To make matters perfectly clear it deserves notice that there is a distinct difference between the rediscounting system on the Continent and the U. S. A. on the one hand and the discounting of bills by the Bank of England.

On the Continent and the U. S. A. the rediscounting of bills is a daily business of the banks. The bills flow from the clients through the smaller banks and bankers to the biggest banks and finally to the Reserve Bank. The assets of these Reserve Banks contain a considerable number of re-discounted commercial paper, being the most important part of the cover of the fiduciary issue. The banks and bankers hold a large amount of bills and get them gradually re-discounted when they take in new bills from the clients. The result is, that the Reserve Bank as well as the banks and bankers hold always a large number of bills, which are gradually repaid and replaced by newly discounted and re-discounted bills respectively. The total holdings vary naturally according to the fluctuations of the volume of business. Generally speaking, the banks and bankers know their approximate re-discount margin with the Reserve Bank and with the bigger banks and bankers and in normal times keep a part of their margin unutilised so as to have a basis of further re-discounting if accomodation is urgently

required. It is evident from the above, that re-discounting is an important part of the daily business of banks and bankers in the U. S. A. and on the Continent of Europe.

The British position on the other hand is entirely different. In London the bills are held by discount houses and bill brokers in normal times who get credit facilities from the commercial banks to hold these bills. In times of monetary stringency the banks withdraw these credits and the bill brokers go to the Bank of England for accomodation. The Bank of England holds in normal times practically no bills as cover of the fiduciary issue, as contrasted with the assets of Continental and American Reserve Banks. The Bank of Englands' fiduciary issue is chiefly covered by treasury bills. The re-discounting facilities of the Bank of England are accordingly a safety device in times of stress.

Reverting to the Indian position it has to be emphasised that the discounting system to be introduced in India is the Continental—American system and not the British system. The British system requires a highly specialised money market (discount market) with discount houses and bill brokers and large amounts of floating short term capitl to hold the bills. Banks—it has to be mentioned for the sake of completeness—hold also bills to a certain extent, but it is not the chief line of their investments and the banks in the U. K. never go to the Bank of England for re-discounting their bills.

As bankers in India, British as well as Indians are naturally better informed about the British position of re-discounting than about the Continental—American system, it is natural that apart from the unpleasant experience gathered in India as expressed by Mr. Bowie in his above quoted evidence, they rather feel shy to ask the Imperial Bank to-day and will feel shy to ask the Reserve Bank, to-morrow, for accomodation, for they know that the banks in England do not ask the Bank of England for accomodation.

As a matter of fact the Bank of England is not a "bankers bank" in the Continental—American sense. It is correctly speaking more a banker to the money market.

A further disturbing element in this respect was brought in by a passage of the Hilton Young Report relating to re-discounting :—

"What has less clearly emerged from the evidence but none the less needs emphasis is how essential it is for the development of banking generally that the foundations of the credit organisation should be truly laid. This will only be the case if the commercial banks (a phrase in which are included both exchange and indigenous banks) are able, *when the necessity arises*, to turn into cash a maximum of their assets with a minimum of disturbance to general conditions. It is only through the establishment of a central banking system, with the facilities of re-discounting it affords, that this end can be achieved. Not until then does the commercial banks' most legitimate assets, viz., a short term advance against goods in the form of a commercial bill become a quick asset capable of prompt realisation *in time of stress.* The system, in fact, enables the commercial banks to regard their holdings of commercial bills as their secondary reserves".* (Para 83)

Unfortunately the above lines of the Hilton Young Report have gone far in order to strengthen the belief of bank managers in India that the rediscounting of bills takes place only in "times of stress". Several bank managers who have read the Hilton Young Report have pointed to para 83 with the remark that should they approach the Reserve Bank for rediscounting their bills it will most certainly be regarded as a sign of weakness if publicly known.

The above passage of the Hilton Young Report has gone far to increase the shyness of banks as regards asking for accomodation. It is is true that para 116 of the Hilton

*Italics are ours.

Young Report has in very general terms described the rediscounting system more on the Continental,—American lines, but the impression created by the rather pointed remarks of para 83 made an impression of a much greater influence on the mind of bankers in India.* It deserves notice that the word "bank" is not even mentioned in para 116.

The most important and at the same time the most intricate task of the management of the future Reserve Bank will be to overcome this difficulty and to induce the scheduled banks to approach the Reserve Bank for accomodation. This can be achieved only through personal influence and through a most intimate touch with the head of the scheduled banks and through, what may be described as educational work.

It will also be necessary to give detailed informations about the bills which will be acceptable to the Bank and about the credit margin of the individual banks by the way of informal and private meetings. It has been suggested in evidenee to the Central Banking Enquiry Committee, that the Governor could ask all the banks to come forward on one and the same day in order to avoid rumours.

Sir Ernest Harvey remarked, replying to question No. No. 365 of the MacMillan Committee, that :—

*Para 116 of the Hilton Young Report reads as follows "It is evident that a limitation of the monetary circulation to the real needs of the country postulates contraction and expansion of the currency in accordance with those needs. In a mainly agricultural country like India those needs fluctuate widely, not merely according to the seasons of the year, but also according to the abundance or otherwise of crops and the prices they command. If that part at any rate of the notes which the Bank issues to meet the need of expansion is secured by assets of a character corresponding to this need of expansion, that is, if these assets mature and are liquidated when the increased monetary circulation is no longer needed, the process of expansion and contraction becomes almost automatic. The true commercial bill, that is a bill drawn in respect of a genuine commercial transaction, has this characteristics in a pre-eminent degree. It is a self liquidating asset in the sense that the liquidation of the commercial transaction liquidates the bill. It is for this reason that the charters of most of the central-note-issuing banks provide for their note-issue to be secured partly by commercial bills. The charter of the Reserve Bank of India should contain a similar provision."

"The relations between the Bank (of England) and the discount market are exceedingly intimate."

It is hoped for the sake of the success of the Reserve Bank that the relations of the Bank and the scheduled banks will not be less intimate in India.

§ 4. *The money market and acceptance credit.*

In connection with the future development of credit in India the remark is often made that every effort should be undertaken in order to develop a bill market in India, and also, that in connection with the development of a bill market, bill brokers, discount houses and acceptances houses shall come into existence.

As this desire is so often expressed a few words will be necessary to clear these further problems of the future credit structure of this country.

First of all it may be remembered, that, as explained above, the introduction and well functioning of the discounting and rediscounting system requires no money market in a new sense and no special bill brokers, or discount houses. The entire business is transacted between the clients, the banks and the Reserve Bank. If as emphasised, the indigenous bankers would also be linked up to the Reserve Bank it would be far more advantageous specially if it is considered that there are hundreds of fairly important places in India where there are neither banks nor branches of banks at present.

The idea of money markets, bill brokers, acceptance houses etc., has been brought into the picture by comparing Indian conditions with highly developed Western countries, where there is an abundance of short term liquid capital and where acceptance credit is more in use than the discounting of bills.

Acceptance credit is, no doubt, a higher stage of credit

evolution as compared with the discounting of bills. The bill of exchange, which is the basis of discounting and rediscounting comes into being if the seller grants credit to the buyer. The risk of the failure of the buyer is thus borne primarily by the seller. The discounting bank naturally examines both signatures but discounts roughly speaking generally on the standing of the seller who approaches the bank for rediscounting facilities. When later on the Reserve Bank rediscounts bills it considers chiefly the credit of the bank that asks for rediscount facilities, although the other signatures are also important.

Acceptance credit as practised in Western countries is based on the guarantee of a bank granted to the buyer and is actually carried out by the fact that the bank accepts a draft drawn on it by the buyer. Thus the seller is not involved in any granting of credit.

Such an acceptance, which in form is a bill of exchange, can be sold to the accepting bank itself if the bank wishes to invest its liquid funds in this way, or it may be sold in the money market to bill brokers, or as a matter of fact to anybody who wishes to invest liquid funds in such acceptances which bear the signature *i.e.*, the guarantee of a first class bank or accepting house. Such first class bank acceptances are sold and bought in the Western money markets usually below the bank rate.

It deserves notice, however, that acceptance business can only flourish if there is a money market with abundant short term funds and if there are bill brokers, and acceptance houses in existence. At present there are no such institutions in India and short term liquid funds of the banks are usually invested in treasury bills.

Economic institutions are as a rule, the outcome of a gradual and organic evolution and although it is possible to create a Reserve Bank by law, that will also certainly

feel the difficulties of not being the outcome of a natural evolution. It is altogether impossible to create straight away money markets, bill brokers or acceptance houses for such business institutions are not constitutional bodies as a Reserve Bank created by an Act of the Legislature, but are business propositions which come into being only under suitable circumstances. It is another question how such circumstances could be gradually created by a far reaching policy of a Reserve Bank, but it is absolutely sure that no such evolution will be possible if the indigenous banker is not even mentioned in the Reserve Bank of India Bill.

The indigenous banker only, if suitably connected with the Reserve Bank can lay down the foundations of a better functioning money market in India.

Special attention has to be drawn to Sir Basil Blacketts' short but remarkably clear and precise Memorandum submitted as his statement of evidence to the Central Banking Enquiry Committee.*

The Memorandum, bearing the title :—

"The acceptance credit, and its application to trade in India,"

makes it perfectly clear that with the help of acceptance credit the financing of the important crops of this country could be greatly facilitated.

The financing of crops is scarcely possible with the help of discounting such bills as are drawn by the seller on the buyer as has been explained above. It has therefore to be considered that in view of the fact, that as acceptance credit in the absence of a suitable money market, bill brokers and acceptance houses, will not be practicable in the Western sense in the near future, it may not be possible to introduce a method greatly in use for the financing of crops in Eastern Europe.

*Volume II Written Evidence, pages 450-454.

According to this proposed method the produce merchants of high standing draw on such banks as authorise them to do so, and thus obtain cash from the banks for financing the marketing of crops.

The banks in turn rediscount these drafts, accepted by them, with the Reserve Bank. In view of the fact that the Reserve Bank is authorised to buy or rediscount promissory notes bearing two good signatures etc., as prescribed by para (*a*) of sub-clause (2) of clause 17, this method seems also possible and appears to be more suitable than a mere promissory note.

In conclusion it may be emphasised that the Reserve Bank Bill gives ample possibilities to foster the systematical evolution of the Indian credit structure if the indigenous bankers are also included within the framework of the Reserve Bank.

§ 5. *Conclusions.*

The only solution of a sound expansion of currency and credit is the introduction of discounting and rediscounting facilities in India. If credit is expanded in the right directions with the help of this method, production and consumption would decidedly tend to increase towards an ideal state of affairs. As regards India, specially cottage industries could be greatly helped if their credit needs could be satisfied by the Reserve Bank through the channels of the co-operative organisations. Such an expansion of credit could encourage the growth of the constant volume of business without disturbing the equilibrium of prices and exchange rates even if Sir Basil Blacketts suggestions about higher price levels and indifference as regards the rate of foreign exchange rates are ruled out altogether.

The rediscounting system, if successfully carried out, offers special advantages to India in order to tide over the monetary stringency caused by the busy season. The

seasonal expansion would correspond to the actual requirements of trade, without a compulsory rise in the bankrate and an automatic contraction would take place with the advent of the slack season.

It appears that the rediscounting system would bring two distinct advantages to this country :—

1. A device to satisfy the credit needs of the busy season efficiently and inexpensively and
2. to expand the constant (non-seasonal) volume of business *i.e.*, production and consumption in general.

A brief summary of the credit problem was only possible. It is hoped that this attempt has conclusively proved that Sir Osborne Smiths' forecast, that if the introduction of the rediscounting system would not be a success, the Reserve Bank would not function at all, is by no means exaggerated.

If the rediscounting system does not take root in India, the Reserve Bank could scarcely do more than to carry out the present task of the Controller of Currency plus investing the funds at the disposal of the Banking Department. That the establishment of such a Reserve Bank would be altogether unnecessary may be generally accepted.

CHAPTER III.

THE WORKING OF THE RESERVE BANK.

§ 1. *Introductory.*

The White Paper proposed that responsibility at the Centre for finances can only be inaugurated if a newly established Reserve Bank will be operating successfully. The previous Chapters attempted to analyse certain points as regards the working possibilities of the Bank. It remains now to visualise the possible working of the proposed Reserve Bank from a general angle and to try to outline what may be considered a success. There is naturally no such standard in existence with the help of which success can be absolutely measured, but it is probably possible to frame such conditions which if fulfilled may be reasonably regarded as a certain grade of success.

A period of about five years—it is felt has necessarily to be allowed for the first beginnings.* The exceptional difficulties of establishing and starting a Reserve Bank should not be neglected. A great deal of experimenting will have to be done at the commencement. After three to four years, the outlines of a more stable policy will, it is supposed, gradually come into existence and then the question may be asked whether the Bank is operating successfully or otherwise. As mentioned the expression "success" is a rather relative term and therefore it may be limited between two extreme possibilities, *i.e.* what is the minimum requirement of being successful and what may be regarded as a real success recognised by everybody.

*The provision that promotes drawn against cash credits (para (e) sub-clause (4) clause (17) may be accepted as security against advances by the Reserve Bank during a period of five years only, seems to point to the same assumption.

Two extreme opinions have been generally expressed in a layman way about the future of the Reserve Bank. (Some people hold that the Bank will just carry on the present task of the Currency Department of the Government of India in the Issue Department, and try to invest in some way or other the funds at the disposal of the Banking Department. Whether bills for rediscounting will come forward may be regarded as doubtful according to this opinion.) On the whole, this class of people may feel, that the Reserve Bank will just carry on somehow, just muddle through and if it does not fail to carry on in such a modest way it may be regarded as a success.

Then there is the opposite view. Some optimists believe that the advent of a Reserve Bank will change the economic structure of the country in the shortest time, (they are sure that the credit facilities given by the Bank will rejuvenate industry, trade and agriculture from the outset, and that a great improvement of economic conditions will be the result.) In other words the Reserve Bank is bound to be an eminent success. The truth seems to lie somewhere not quite midway, but slightly left from the middle, if the right is taken as the optimistic view.

Para 2 of the Introduction of Part II emphasised that the management should try to find out such lines of improvement, which according to its mature judgement are for the ultimate benefit of the nation as a whole. It may be added that, it will not be a simple task to frame such a policy. If it would be as simple, as theorists believe, to initiate such a policy, which could improve suddenly the economic conditions of a country, it may be argued in reply that there would be no world economic and financial crisis. On the contrary prosperity would be ruling all over the world.

In view of the difficulties of a correct management of the proposed Reserve Bank it will have to be outlined now, how a satisfactory conduct of the day to day business

of the Bank may be visualised and how such a broad policy may be framed, as will ultimately go far in bringing about the best possible results.

§ 2. *The first beginning.*

Let us start at the outset and assume again that the Reserve Bank would have been started on the first of September 1933, furthermore that the sterling assets would have been increased to the necessary minimum and that *ad hoc's* reduced so as to allow 50 crores of rupee coin to be included in the Reserves. The position would then be as under :—

Issue Department
Lakhs of rupees.

Assets.			Notes in circulation.
I. External assets :			180,00
Gold ..		44,35	
Sterling ..		45,65	
		90,00	
II. Internal assets.			
Government of India rupee securities		40,00	
Rupee coin ..		50,00	
		90,00	
Total		180,00	180,00

Banking Department.
Lakhs of rupees.

Assets.			Liabilities.		
Notes and coins (15%)		270	Capital	..	5,00
Investments and advances	..	15,30	Deposits		
			(*a*) Government	..	8,00
			(*b*) Banks	..	5,00
Total	..	18,00	Total	..	18,00

As a rough guess, Government deposits have been taken as 8 crores of rupees on the average and the compulsory deposits as 5 crores, which is no doubt a too low figure.

In view of the assumptions of Chapter II a few words will suffice now to visualise the possible working at the beginning. The actual task at the outset will be to invest the funds at the disposal of the Banking Department. According to clause 17 these funds can be invested in the following way :—

Sub-clause (2) (*a*) Commercial bills or promissory notes.
(*b*) Agricultural bills or promissory notes.
(*c*) Bills or promissory notes drawn against giltedge.

Sub-clause (3) Sterling balances, bills of exchange and sterling securities.

Sub-clause (4) Loans and advances against the security of :—
(*a*) Trustee securities.
(*b*) Gold.
(*c*) Rupee bills or promissiory notes.
(*d*) Sterling balances or bills of exchange.
(*e*) Promissory notes drawn against cash credits.

Sub-clause (5) Ways and means advances to the Government of India.

Sub-clause (7) Rupee securities of the Government of India and Local authorities.

It will rest with the management how to conduct the policy of investments as regards earning interest and maintaining security. How the forthcoming of commercial and agricultural bills can be encouraged has been fully discussed in Chapter II.

Apart from these investments the following functions will also be performed by the Reserve Bank :—

Clause 17,	sub-clause (3)	Selling and buying sterling on behalf of Government authorities.
Clause 40 and 41		Selling and buying sterling at 1sh. 5-49/64d. and 1sh. 6-3/16d. respectively, if necessary in order to maintain the rupee sterling ratio between the upper and lower points.
Clause 17,	sub-clause (6)	The issue of demand draft etc.
	sub-clause (9)	Safe custody etc.
	sub-clause (11)	Acting as agents to transact banking business of Government authorities.
	sub-clause (12)	Purchase and sale of gold coin and bullion.
	sub-clause (13)	Acting as agents or correspondents of Central Banks of sterling standard countries.
	sub-clause (14)	Borrowing from foreign Central Banks or from the scheduled banks.

Open market operations in view of their importance will be dealt with separately in the next para.

If the rules regarding the reserves will be enacted as proposed by the Bill, the investments and the rediscounting of bills will be limited at the commencement practically to the funds at the disposal of the Banking Department.

Should however a lowering of the percentage of the

external assets be considered, a further expansion of credit could take place if the volume of business in India can absorb more notes in circulation than at present.

If no such lowering of the percentage of the external assets takes place, then only an inflow of sterling would allow for an expansion of the note circulation as explained in Chapter I.

The possible earning capacity of the Reserve Bank at the beginning has also to be visualised in view of opinion expressed that a Reserve Bank is a luxury which can hardly be afforded by this country.

Taking the position as assumed above the gross earnings may be forecasted as under :—

Issue Department.	Lakhs of rupees.
Interest on sterling securities (1½%)*	68
Interest on Government of India rupee securities (3½%)	140
Banking Department.	
Interest on investments and advances 4%	61
Total ..	269

In order to obtain an idea of the net profits, the estimated expenses will have to be deducted from the gross earnings.

The expenses of the Issue Department may be taken as equal to the expenses of the present Currency Department	45
The expenses of the Banking Department can only be estimated, say at	30
Total ..	75

*The interest rates and the expenses are estimated on the safe side.

Deducting 75 lakhs from the gross earnings, 194 lakhs (39%) would remain for distribution according to the rules laid down in Clause 44.

§ 3. *Open market operations and the automatic working of the sterling exchange standard.*

Open market operations in general and the automatic working of the gold standard have been explained in Part I, and now, it will have to be attempted to elucidate the actual position with regard to the proposed Reserve Bank and the sterling standard currency system.

There are in fact three factors to be considered.

Firstly the automatic working of the sterling exchange standard, *secondly* the actions of the public as regards hoarding and releasing sterling and internal currency and *thirdly* the open market operations of the Reserve Bank intended to counteract the first two factors if they are not in accordance with the policy of the Reserve Bank.

(*a*). *The automatic working of the sterling exchange standard.*

As a matter of fact there is no great difference between the automatic working of the gold standard, as compared with that of the sterling exchange standard.

If economic conditions in India improve so that the balance of trade and payments becomes more and more favourable, the consequence would be that sterling would flow into the country, instead of gold, as on the gold standard. The consequences of an inflow of sterling are also the same as those of gold. The currency expands, for the superfluous sterling would finally reach the Issue Department of the Reserve Bank and be included as an asset against notes issued. The expansion of currency would raise prices, lower the rates of interest, and gradually initiate a swing of the pendulum towards the opposite direction.

Lower interest rates cause foreign short term capital to leave the country, the more as under such conditions the rate of foreign exchange would be near to the upper point (1sh. 6.3/16d.). Higher prices would gradually check exports and encourage imports and thus make the balance of trade unfavourable and as a consequence the inflow of sterling may be converted gradually to an outflow of sterling.

An unfavourable balance of trade and payments would naturally have the opposite effects. Sterling would leave the country. The Reserve Bank might have to sell sterling if the lower point (1sh. 5.49/64d.) is reached. A sale of sterling by the Reserve Bank contracts currency, a contraction lowers prices, lower prices stimulate exports, check imports which tend again to turn the balance of trade towards a more favourable position. Contraction of currency will also raise the interest rates and higher interest rates will induce the inflow of foreign capital which also acts towards raising the foreign rate of exchange and towards the lowering of interest rates. These sketchy remarks may suffice to indicate that the automatic working of the sterling exchange standard corrects automatically every extreme position of favourable or unfavourable foreign balances just as the gold standard.

Naturally, if the position on account of bad economic conditions remains for a long time unfavourable the sterling reserves may be exhausted gradually and also the gold reserves and then the sterling exchange standard would also break down just the same as the gold standard. Foreign loans can also in the case of this standard delay the breakdown, but in the long run a country cannot go on taking foreign loans. A breakdown has either the consequence of a drop in the rate of foreign exchange or the introduction of exchange restrictions.

Broadly speaking there is no great difference in this

respect, between gold standard and sterling exchange standard.

The Reserve Bank may, if the necessity is felt counteract the effects of the automatic working with the help of open market operations and it may also if, circumstances so require, encourage it.

Before depicting the automatic working, a few remarks are to be made about the actions of the public, as such events may also influence the open market policy of the Reserve Bank.

(b). *The actions of the public.*

Actions of the public may also necessitate open market operations, in order to be counteracted if not in accordance with the policy of the Reserve Bank. The analysis of actions of the public in connection with currency and exchange matters, have been analysed in detail on pages 36 and 37 and need no recapitalution here, as the position in India would not be different as to the general description given in Part I.

(c). *Open market operations of the proposed Reserve Bank of India.*

Open market operations may be conveniently divided into two main groups. The *first* group includes open market operations connected with the desire to make the exchange policy of the Bank more effective than can be achieved, by a rise or a decrease of the bank rate. The *second* group of operations are carried out in order to make the credit policy of the Bank effective if a rise or lowering of the bank rate has not been effective.

(i) *Open market operations in connection with foreign exchange policy.*

The fluctuations of the foreign exchange rate may not be in accordance with the policy of the Reserve Bank.

Firstly a fall in the exchange rate coupled with an outflow of sterling may change the position of the external reserves. Under such circumstances first of all the bank rate will be raised with the hope that it might cause a contraction of currency and that as a consequence of the higher rate of interest coupled with a low rate of the rupee sterling exchange, foreign capital may flow into the country. If however the position becomes worse and the bank rate proves not to be effective, open market operations may be carried out by the Bank. Such operations will consist of selling internal securities in the market so as to contract currency. A strong contraction of currency will lower the price level and have the consequences described above. Such operations may be carried out by the sale of Government securities or by the sale of commercial paper in the money market. It is, as explained in Chapter I, not possible to carry out such operations at the beginning, for there will be no saleable Government securities, and no rediscounted commercial paper within the assets. It may here also be added that if later on the Bank will hold rediscounted commercial paper, it will not be possible to sell such paper in the absence of a money market, where bills can be bought and sold as in Western countries. For a long time to come it is not expected that such a market will come into existence in India.

Secondly open market operations may be carried out to counteract the effects of an inflow of sterling if the Reserve Bank feels that an unsuitable expansion of currency will raise prices too high and create excessive and undesirable speculation. Such an operation is similar to the sterilisation of gold as described on page 24. The sterlisation of superfluous sterling may be carried out by selling internal assets *i.e.*, Government securities or commercial paper. These operations will also not be possible at the beginning for reasons stated above.

(ii) Open market operations in order to make the credit policy of the Bank effective.

Apart from the regulation of the external position it may be necessary to operate in the open market in order to contract or expand internal credit. For instance the Bank may desire to break down excessive interest rates and will undertake to discount bills directly, as provided for in clause 18. The purchase of Government securities may also serve this purpose if the upper limit is not reached. On the other hand the Bank may desire to contract credit, for instance to check excessive speculation. For this purpose securities or commercial paper would have to be sold. Such sales as explained above will not be possible at the beginning out of the assets of the Issue Department. How the actions of the public as regards hoarding or release of currency or foreign exchange may be counteracted is described on pages 37, 38 and 39.

The composition of the assets of the Issue Department at the beginning will not allow for such open market operations as has been emphasised several times above, but it deserves notice that such open market operations may partly be carried out with the help of the assets and funds of the Banking Department.

It is more or less sure that a similar reasoning has induced Sir Osborne Smith to give the following explanation of the necessity of the compulsory deposits of the scheduled banks, in his evidence to the Central Banking Enquiry Committee :—

"I consider it absolutely essential to the control of credit, that the exchange and other Member Banks must keep an adequate susbstantial percentage of their call and time liabilities with the Reserve Bank and this is a primary reason why the Central Institution should be debarred from doing ordinary business" (Volume II Written Evidence, page 848).

It is hoped that this rough outline of the possible open market operations may suffice to give a superficial idea about such operations. Time and space forbids, unfortunately, to enter into further details.

§ 4. *The importance of credit expansion.*

Great stress has been laid on the fact that the rules as regards the composition of the reserves should be so amended that a suitable expansion of currency could take place at any time right from the outset, as the intitial position will not make an expansion possible if the propositions of the Bill are enacted.

This tendency has been emphasised for important reasons, which are directly connected with solutions as have been advocated by most prominent economists, reports of wellknown committees and by leading statesmen.

These suggestions are fairly well known and therefore it seems to be unnecessary to go into full details. A short summary may suffice to recapitulate these ideas.

The world economic crisis has been chiefly created by conditions which have lead to a gradual contraction of currencies all over the world since 1929. The most important of these conditions are the hoarding and sterilisation of gold by the U. S. A. and France. The boom in the U. S. A. up to 1929 and the payment of reparations and War debts in gold instead of by exporting commodities, coupled with the reluctance of creditor nations to continue lending to debtor countries has brought about these conditions. An unprecedented fall in prices followed and all the well known consequences, that are known as the world economic and financial crisis. The relationship of debtors and creditors is as a consequence out of gear to the detriment of both.

It has been gradually recognised by leading men in

the British Empire and in the U. S. A. that only higher prices can bring about a solution of the present difficulties and that higher prices can only be achieved by an expansion of currency. There is a remarkable unanimity in this respect between the leaders of British Economic thought and the chief representatives of the Indian Commercial Community. Mr. G. D. Birlas' Note on the "Present Depression and its Cure (1931) the various Memoranda of Sir Henry Strakosch and" Planned Money" (1932) by Sir Basil Blackett may be compared in order to verify this statement.

Official reports such as chiefly the MacMillan Report (1931) and the Report of the Gold Delegation of the League of Nations (1932) have expressed the belief that an expansion of currency and credit is necessary in order to bring about better economic conditions.

. Recently the importance of starting public works and to create suitable occupations for various unemployed or neglected classes of the population have also been stressed. Here again the similarity of ideas between the articles recently published by Mr. J. M. Keynes and the Memorandum on "Economic Policy of Bengal" submitted by the Indian Chamber of Commerce, Calcutta, deserve notice although they relate to entirely different conditions.

Reverting now to the Reserve Bank Bill it may be rightly asked, why has the Bill not been so framed as to allow for such a necessary expansion of currency at the commencement when this desire has been recognised as the only way out of the crisis ?

It may be specially stressed that those two prominent experts of public finance. who are at present in charge of the finances of this country Sir Henry Strakosch and Sir George Schuster have on various occasions emphatically expressed their belief that only a substantial rise in prices can be regarded as a remedy.

Apart from the Memoranda by submitted Sir Henry Strakosch to the MacMillan Committee and to the Gold Delegation, both Sir Henry as well as Sir George Schuster have stressed the importance of a rise in prices in their speaches at the Imperial Economic Conference at Ottawa in July 1932.

It may be hoped, that the Bill will be so amended, that a suitable expansion of currency may take place in order to raise the price level if action is decided upon.

§ 5. *Relations of the Reserve Bank with banks and bankers.*

The position of the Reserve Bank in connection with the scheduled banks is of great importance especially as it has been widely held that it will be extremely difficult for the Reserve Bank to exercise any control or influence on the Exchange Banks, for these banks may obtain practically unlimited finance from their Head Offices, which are situated in various important money centres of the world.

The analysis of the automatic working of the sterling exchange standard and the possible effects of open market operations give a certain basis in order to judge this problem and reveals that the position is not as unpleasant as is generally believed.

First of all it may be stressed that the in and outflow of foreign capital, mentioned in connection with the automatic working and the open market operations will, practically without exception, enter and leave the country through the Exchange Banks.

The fear that the banks might keep the rates of interest high and the Reserve Bank will have to step in and utilise the powers granted by clause 18 to discount bills directly is not connected with the foreign side of the business, but purely with internal credit matters.

The reason why the Reserve Bank should be provided with compulsory deposits from the scheduled banks free of interest has been explained above and it may be added that the Reserve Bank will not be able to control credit even with the help of an additional 10 crores of rupees, if the composition of the assets of the Issue Department will not be helpful in this respect. It is however understandable, that the banks will not be satisfied with a provision prescribing to hand over to the Reserve Bank an important part of their funds, which earn interest at present, in order to get these funds, back in the shape of advances or to find them to be utilised against the banks in order to lower the interest rates charged by them. The argument is also advanced by the banks that these compulsory cash reserves will not only not earn interest, but it cannot be used by them in case of emergency.

As regards indigenous bankers it is hard to describe their relation with the Reserve Bank as their existence has been entirely neglected by the Bill. The desire to link up the indigenous bankers with the Reserve Bank has been expressed above and now it may be repeated only that it is requested to carry out the recommendations of the Central Banking Enquiry Committee and the suggestions of Sir Osborne Smith regarding the indigenous bankers.

§ 6. *The relations of the Reserve Bank with agriculture, industry and trade.*

(a) *Effects of expansion of credit on production.*

The most important relationship of a Reserve Bank with the various branches of production, is the extension of credit facilities. Before entering upon the actual Indian problem, the influence of an expansion of currency and credit on production and consumption in general will have to be considered.

The role of bank money within the modern economic

structure has been explained in Chapter II of Part I. Going a step further it is not exaggerated to say, that apart from the magnificent evolution of technique, that has entirely changed human life in the last few decades, such a change could not have had taken place if a wholesale expansion of the means of payments in the form of book entries *i.e.*, bankmoney would not have come into being. Without the help of an enormous expansion of credit, the economic development of the last few decades could not possibly have taken place.

Another aspect is to be stressed too. It deserves notice, that this great economic and technical development has taken place at a time when the silver standard and bimetallism was practically abandoned all over the world except China and when nearly all countries adopted the gold standard. This all round adoption of the gold standard, was equal to a wholesale restriction of the basis of currency.

Unconsciously and unrecognised, as so many new human institutions, the evolution of bank money took place. The leaders of banks were and are the last persons who were and are aware of this event. Thus the limitation of creation of currency, created by the adoption of the gold standard, was counteracted.

The contraction of currencies all over the world caused by the maldistribution of gold as described above, has not yet been counteracted as yet by an expansion of currency and bank money and this alround shortage of the means of payment has depressed the price level and is, as generally recognised the chief cause of the world economic crisis.

Although nearly all the countries of the world are off gold to-day, and although the limitation of gold reserves would be no obstacle now, an expansion of currency and credit has not yet taken actually place in any important country.

The recommendations of important reports have not been carried out, and the promises of statesmen, in-

cluding Mr. Roosevelt, remained on paper. The result is that the price level is at a dangerous low point.

Two entirely different aspects of currency expansion have to be noted.

Firstly, currency and credit has to be expanded if the volume of business expands. More business needs more currency and credit in circulation. Without that a price raising effect would take place and accordingly if any efforts are undertaken to create possibilities of production, for instance, when dealing with unemployment, great care should be taken to expand currency *pari passu* with the expansion of business.

The *second* aspect refers to expansion of currency and credit by itself, which naturally has a price raising effect and should be carried out solely for the purpose of raising the price level to a figure at which the position of creditors and debtors would be readjusted as recommended by the MacMillan Committee in 1931 and by many other Reports since.

Which ever method may be followed, an expansion of currency and credit in the world at large, will have to be effected before a revival of trade, agriculture and industry can take place.

In order to enable the Reserve Bank to carry out its duties towards production, the present inelastic propositions of the Bill will have to be so altered that Indian production could also enjoy the benefits of a currency expansion when, as hoped for, the decision will be made.

For the sake of completeness it also has to be mentioned that there is a school of thought that believes that not the monetary factors, but over production is the cause of the present troubles.

Sir Henry Strakosch in his Memorandum submitted

to the MacMillan Committee gave a classical reply to the advocates of the over-production theory :—

"We are, in these circumstances, entitled to conclude that these exchanges (of stocks of commodities) failed to be made, not because goods generally were in excessive supply, but because the process of exchange was, in some way, impeded. And if, as is the case, there are no observable impediments of a physical or moral character, the theory of "over-production" fails, and we are driven for an adequate explanation to the only remaining factor affecting the process of exchange, viz., the adequacy of the amount of money that is available to effect these exchanges". (Evidence, MacMillan Report, Volume II page 28, para 13).

(b). *The duties of the Reserve Bank of India towards production.*

Assuming that the rules as regards the composition of the reserves will be so changed in the Bill, that an adequate expansion of currency and credit can take place if necessary from the outset it will be one of the most important duties of the Reserve Bank to find out in co-operation with the leading representatives of agriculture, trade and industry where such credit facilities may be given on a sound footing which could go far in encouraging production and consumption and would raise thereby the standard of living of the masses.

It is outside the very limited scope of this book, to go into details but at the same time attention has to be drawn to the existing possibilities and at least bare outlines have to be given.

i. Agriculture.

The Bill has provided for rediscount of agricultural paper and also for taking such paper as a security against

loans and advances. It may be hoped that the relations between the Reserve Bank and the Co-operative Banks will be an intimate and happy one. As will be stressed also in connection with trade and industry it is sincerely hoped that the management will take a personal interest in all problems connected with the development of the economic life of India, just as has been taken by Mr. Montagu Norman and Sir Ernest Harvey in Great Britain (see footnote page 49). There is a great deal of spade work to be undertaken before any new venture comes up for actual finance. If the management will take an active interest in all sound economic plans it will be much easier to so frame matters as to allow for adequate credit facilities.

The future of agricultural progress will depend greatly on the development of the co-operative movement and the Reserve Bank could go far in fostering this so important organisation. The recommendations of the Central Banking Enquiry Committee should be carried out as far as possible.

The question of linking up the indigenous bankers with the Reserve Bank has to be stressed again in this connection. It is a wellknown fact, that far the greatest part of agricultural credit is actually financed by indigenous bankers. It is strongly recommended, therefore to reconsider the case of this so important community and to include suitable provisions in the Bill.

ii. Industry.

Even the most extensive tariff protection granted to Indian industries cannot suffice if the necessary finance is not forthcoming. It is most decidedly not the intention of this book to advocate that a Reserve Bank should be helpful in providing initial capital to industries though the Bank of England, in connection with the Securities Management Trust and the Bankers Industrial Development Com-

pany, has gone further than Central Banking practice usually would go.

The provisions of the Bill and especially the loans to be granted against the security of promissory notes drawn against cash credits (clause 17 (4) (*e*)), will give ample facilities to promote industrial finance as regards short term accomodation from the Reserve Bank and to educate the clients to provide for the necessary negotiable instruments.

iii. Trade.

A very important domain, where the discounting of bills could bring about better conditions is no doubt inland trade. Sound credit facilities could go far in fostering trade, though one condition has to be emphasised namely, that a fairly severe discipline will have to be maintained as regards payments on the due date.

In this connection it should not be forgotten, that the volume of foreign commercial credits, which were granted by foreign manufacturers in connection with imports, is gradually diminishing, *firstly* as a consequence of replacement of imported goods by Indian made goods, and *secondly*, as a consequence of the crisis, less credit is granted on account of a lack of confidence.* Such foreign credits are replaceable by the introduction of discounting and rediscounting bills.

§ 7. *Conclusions.*

The idea to establish Economic Councils in India was

*It is worth while to note, that economic theory has rather neglected the role of such credits, as are not granted by banks but by manufacturers and traders out of their own liquid capital. It is the special merit of Mr. Jacques Rueff to have draw attention to this fact. See Selected Documents submitted to the Gold Delegation of the League of Nations.

taken up a few years ago. Sir Arthur Salter was specially invited to investigate this matter. A report was submitted but nothing has been undertaken as yet. On the other hand one is inclined to feel, though this view may be wrong, that such Councils could not achieve a far reaching effect. It is decidedly felt on the other hand, that within the framework of the Reserve Bank much could be done in the same direction, as for which the Economic Councils were intended. The Central and the Local Boards could and should take a great interest in all important economic matters, apart from the conduct of their daily business.

Summing up, the belief may be expressed, that the institution of a Reserve Bank could not only go far in actual finance of production, but also in bringing about informally a mobilization of the best brains of the country, in order to meditate, to plan and finally to carry out reforms for a better future of the masses.

CHAPTER IV.

STATE BANK VERSUS SHAREHOLDERS BANK.

The Bills of 1927 and 28 were wrecked by the controversy whether the Bank should be a State Bank or a Shareholders Bank.

A perusal of the debates of the Legislative Assembly in 1927 and 28 regarding the Reserve Bank Bills, reveal the fact, that not even the surface of the essential problems of the working of the proposed Reserve Bank were touched.

It has been mentioned above, that the only attempt to visualise the working of the proposed Bank was undertaken by the Members of the Central Banking Enquiry Committee in course of their discussions with Dr. Trip. The details of the problem, how a State Bank or a Shareholders Bank would function has, however, not been analysed.

Even a fairly superficial examination of the possible working of the two types makes if perfectly clear that should have an attempt been made in 1927 to visualise the working of the Bank, the result would perhaps have been not less than to change the position of the parties.

Let us forget now the Assembly debates of 1927 and 1928 altogether and let us face the problem with an open mind.

(*a*). *The Shareholders Bank.*

The working of the Shareholders Bank as proposed by the Bill has been examined in Part II. This examination made it perfectly clear, that the shareholders can exercise a decisive influence on the management of the Bank.

First of all they have to elect the Members of the Loca Boards, who in turn elect the Directors. The elected Directors form a majority of eight against the Governor and the four nominated Directors in case they disagree. The Governor General can only remove an elected Director if a majority of 9 Directors agrees, a position, as mentioned on page 59, which can never occur if the elected Directors hold together. Though the Directors cannot convene a meeting of the Central Board, they can convene a general meeting and can give full publicity to their views against the policy of the Governor.

At such a meeting the of shareholders can also express their dissatisfaction with the management and, at the annual General Meeting they are not bound to pass the balance sheet as proposed by the Central Board.

The position of the elected Directors versus the Governor has also been clearly stated. If not satisfied with the policy of the Governor the elected Directors can vote on every occasion against the Governor and create a complete deadlock. The Governor General in Council can remove the Governor at any time should he carry out a policy dictated by the elected Directors, which is not in accordance with the wishes of the Governor General in Council, but such a removal would not solve the problem, for the next Governor would be exactly in the same difficult position.

The view has been expressed that although the Reserve Bank shall be free from political influence *i.e.*, from the influence of the Legislature at the same time there is a possibility that the Secretary of State or the Governor General can exercise a decisive influence on the Bank. Against this opinion it is submitted that even a superficial perusal of the Bill will furnish ample evidence that the Governor General in Council or the Secretary of State through the Governor General in Council will never be able to exercise the slightest influence on the management, if their

views are contrary to those of the majority of the elected Directors the shareholders.

The actual outcome of such a difference of opinion will be the creation of a complete deadlock which can only be removed by a compromise as otherwise the Reserve Bank will not function at all.

Let us take a practical angle and depict an extreme situation. According to the provisions of the Bill the Bank will work during the first four years for all practical purposes as a Government Bank for the simple reason that all Directors will be nominated by the Governor General in Council. After 2 years the four elected Directors will be in a minority against the nominated Directors.

This first four years may be regarded as a period of trial. During this time there will be ample opportunity to observe whether the policy of the Governor is beneficial to the country or not. It has after all to be stressed that the Governor can exercise enormous influence on the economic life of the country which can be equally beneficial or detrimental.

Should the first four years prove that the Bank is not managed in the interest of the country or that it is just dragging on without initiative, then all shareholders who are aware of their national duties will be in a position to come forward and elect such Directors who will put forward a national economic policy.

Under such circumstances the above described deadlock may arise or on the other hand a compromise may be reached.

Two important aspects deserve notice as the outcome of the above reasoning.

Firstly that a decisive political influence can be exercised on the working of the Bank if it is a shareholders Bank.

According to official ideas, however, such an influence is not called "political influence" for the simple reason, that it is not connected with the Legislatures. But in the practical sense of "political parties", very great inofficial political influence can be exercised through the elections and through the outcome of the elections on the elected Directors. As a matter of fact it is not unlikely at all, that the elections of the Local Boards may become far more important political events than the elections for the Assembly, Legislative Councils or Corporations. There is no prohibition whatsoever to organise propaganda meetings of shareholders, to distribute pamphlets and, last but not least, to undertake every effort in canvassing for votes.

Secondly the question may be asked, what will be the probable outcome of such possibilities ? The reply is simple, it will most likely,—and it may be added,—it is hoped most certainly, come to a reasonable compromise.

After all it has to be considered, that practically all controversial subjects, end in a compromise,where all factors and forces are united in a suitable way.

The evolution of the constitutional reforms of our country also proceeds in a gradual progress by the way of compromises and one should not expect under such constitutional conditions anything else but a compromise.

In conclusion of the remarks regarding a Shareholders Bank it may only be stressed, that the forthcoming of such compromises is practically sure and inevitable. After all it is most unlikely that either the Governor General or the elected Directors will let the Bank end in a deadlock, which would have the consequence of the Governor General's taking over the note issue as provided for in clause 30. It is quite natural that in case there is a conflict of a serious nature between the elected members and the Governor, that negotiations will be taken up and a compromise may be arrived

at. It is also possible that the Governor will resign in such a case for the compromise might not suit him and another Governor may be found who will frame a policy which will be acceptable to the Governor General as well as to the elected Directors.

On the whole it appears that the Reserve Bank will be a sort of a democratic institution, where the Governor can be removed if he comes into a deadlock with the elected Directors, whereas the elected Directors cannot be removed if they all combine.

And finally it may be remarked, that the question whether the four nominated Directors will be nominated by the Governor General on his own initiative or according to the recommendations of the Finance Minister has no practical importance because these four nominated Directors will always form a minority as compared with the elected Directors.

Whether a member of the Legislature should be a Director or not has in the light of the above reasoning also little importance only, for it has been conclusively proved, that the political parties can exercise enormous political influence on the elections and in connection with the general meetings, if they so desire. As a consequence there is no reason to believe that if by mere chance a member of the Legislature is elected a Director he could have more political influence than the political parties in their inofficial way.

In view of the above observations, it may be stated, that from a national point of view a Shareholders Bank is coupled with such safeguards which, if the shareholders take a keen interest are bound to guarantee that the policy of the Bank will have to be conducted in the interest of the masses.

It is interesting to note that a study of the debates of 1927-28 reveals the fact, that it is almost certain that the above possibilities have neither occured to those who have

put forward a Shareholders Scheme, nor to those who have opposed it.

(*b*). *A State Bank.*

The Joint Select Committee to which the Bill of 1927 was referred has submitted a scheme providing for a State Bank.

The Assembly debates of 1927 and 28 prove, that it was generally held that such a State Bank will safeguard the national interests more, than a Shareholders' Bank.

A glance at the chief points of the State Bank scheme reveals, however, that the State Bank, as proposed by the Joint Select Committee, would create a Reserve Bank, which would always be under the direct influence of the Governor General in Council, and the national interests would not be safeguarded at all.

The capital of this State Bank would, according to the scheme, have been subscribed by the Governor General in Council. In other words, expressed in non-legal terms, the *Governor General in Council would be the proprietor of the Bank.*

The Governor and the Deputy Governor are to be appointed by the Governor General in Council. Although the recommendations of the Board are to be considered, the Governor General in Council may appoint whomever *he* selects. As a result the Governor and the Deputy Governor would have been under all circumstances such men, on whom the Governor General in Council can safely rely that they will unhesitatingly carry out his instructions.

The Board of Directors would have consisted of :—

Two Directors nominated by the Governor General in Council,

Two Directors to be elected by the Associated Chambers of Commerce,

Two Directors to be elected by the Federation of the Indian Chambers of Commerce.

One Director to be elected by the provincial co-operative banks.

Three Directors to be elected by the elected members of the Indian Legislature.

Three Directors to be elected by the elected members of the provincial legislatures, and

One officer of the Government, appointed by the Governor General in Council.

The Board of Directors of the State Bank would have met at least once a month and the Governor alone would have had the right to convene a meeting.

Furthermore it has to be emphasised that the Bill drafted by the Select Committee of 1927 contained no provisions whatsoever as regards Local Boards.

If the working of the State Bank, as proposed by the Joint Select Committee in 1927 is visualised, it becomes evident, that such a Bank would have been managed by the Governor according to the instructions of the Governor General in Council, *i.e.*, the Bank would have been entirely in the hands of the executive under all circumstances.

It is perfectly clear, that a Board of a State Bank, the capital of which is held by the Governor General in Council, is in practice not more than an advisory body, and if it does not agree with the policy of the Governor it may scarcely do more than to record its dissent. The fact that these Directors represent Chambers of Commerce, Legislatures, or cooperative banks means from a constitutional or legal point of view nothing, for these bodies are not shareholders of the Bank and have no constitutional rights to interfere with the management of the Bank. As long as the Act does not expressly state that the Governor can only manage the Bank with the consent of the majority of the

Directors, the Board of Directors is only an advising body. If the Directors do not agree to the policy of the Governor they can resign and the body which has elected them, can elect other Directors or, if in order to emphasise its disagreement does not elect any new Directors, such a possibility has also no consequences, for no quorum is prescribed in the Bill, and if all elected members resign the Governor can carry on with the two nominated Directors.

It has also to be considered that a State Bank has naturally no general meeting, where—as is the case with the Shareholders Bank—those who disagree with the policy of the Governor and the Board can give widespread publicity to their opinion, also in case they form a minority.

The above stated explanation of the working possibilities of the State Bank as proposed by the Joint Select Committee in 1927 becomes evident if the clause as regards the management is examined.

Clause 6, reads as under :—

"The general superintendence of the affairs and business of the Bank shall be entrusted to a Board of Directors which may exercise all powers and do all such acts and things as may be exercised or done by the Bank under this Act."

This clause may be divided into two parts :—.

1. The general superintendence of the affairs and business of the Bank, and that

2. the Board of Directors may exercise all powers and do all such acts and things as may be exercised or done by the Bank under this Act.

As regards the *first* point it needs no detailed explanation, that such a "*superintendence*" is of no practical importance at all and can result at the utmost in recording the disagreement of the Board with the acts of the Governor undertaken since the last Meeting.

Now, as regards the *second* part it is sufficiently known that a Reserve Bank has to be managed day by day and whatever the Board can do during the actual time of the Board Meeting once a month for a few hours cannot possibly be described as the management of the Bank. It is generally known that all over the world the Governor, the Deputy Governors and the leading permanent officials manage the Central Banks.

Now, according to clause 6 of the Bill, as proposed by the Joint Select Committee it is possible for the majority of the Board of Directors to carry out all such acts and things as may be exercised or done by the Bank under the Act. Everybody conversant with acts or things which form the management of a Reserve Bank knows that the business policy of the Bank cannot possibly be fixed at a short meeting for a month ahead.

And even if the majority of the Directors would give written instructions to the Governor to act according to their policy, the Governor of the State Bank would most decidedly not be bound by such instructions during the one month interval which takes place between two Board Meetings. The position of the Directors of the Shareholders Bank, on the other hand would be on an entirely different footing, for their instructions* would bind the Governor, as these Directors represent the shareholders *i.e.*, the proprietors of the Bank. The shareholders and also the Directors as shareholders of a Shareholders Bank can most decidedly enforce the wishes of the majority of shareholders and their Directors versus the Governor with the help of the Law, whereas the elected Directors of the State Bank would have no such weapon. As a matter of fact the elected Directors, as laid down in the Bill, proposed by the Joint Select Committee are mere puppets who have no device

*Whether right or wrong from the economic point of view.

with which to enforce their will even in case of a sweeping majority.

A practical example will elucidate the above general statement.

It may be assumed for instance that, at a certain moment when the Reserve Bank is already working, the opinion prevails in wide circles, that an expansion of currency would be the only remedy to bring about better economic conditions. Since responsible British leaders and specially such as hold or held high positions in connection with the finances of the Government of India (*e.g.* Sir Henry Strakosch and Sir Basil Blackett) have done their utmost to convince the world with unanswerable arguments in favour of an expansion of currency, it is natural that the Indian commercial community, which has advocated the same methods years and years earlier will go on asking for such a policy of expansion.

Following up our example both cases have to be examined, *i.e.*, what will happen under the State Bank Scheme and what under the Shareholders Scheme ?

Taking the State Bank Scheme *first* let us assume that the majority of Directors will express their desire that a policy of expansion should be carried out. According to clause 6 they also have the right—*as long as the meeting sits* – to carry out such acts as authorised by the Act in order to expand currency. Such acts are a lowering of the bankrate and a purchase of securities or discounting and rediscounting bills, *i.e.*, open market operations.

It is evident that the Board according to clause 6 can undertake these actions as long as the Board is sitting, but it is just as evident that the moment when the meeting is over, the Governor can do exactly the opposite and can raise the bankrate and stop the open market policy of expansion and go on during one month with a policy of contraction.

The Board, when it meets again after one month can record its dissatisfaction with the policy of the Governor and can—*sticking to the wording of the law* and carrying the example *ad absurdum*—act again for the one, two or three hours during which the Board is sitting in a direction of currency expansions as described above. When the meeting is over, the Governor can immediately counteract the policy of the Board. As stated above in general terms, the majority of the Directors have no possible authority where to appeal, and they have no legal methods to enforce their policy.

A careful perusal of the Assembly Debates of 1927 and 1928 proves that the only member, who felt that clause 6 will not give effective power to the Board was Mr. Vidya Sagar Pandya.

Mr. Pandya moved in the Assembly on the 31st August 1927 :—

"That for clause 6 of the Bill the following be substituted :

6. The management of the business and the control of the Bank shall be vested in the Board who may exercise all such powers and do all such acts and things as may be exercised or done by the Bank under the Act or any Regulations made thereunder".

This motion was negatived.

A glance at Mr. Pandyás suggestion proves, that his suggestion would also not have changed the position of the Board of a State Bank, but it is important to record, that he *felt*, at least, that clause 6 as embodied in the Bill gives practically no powers to the Board of Directors.

Summing up the position of a State Bank it has to be emphasised that no such Bill can possibly be drafted which could exclude the absolute predominance of the Governor General and the Secretary of State on a State Bank under the present conditions and under the conditions as proposed in the White Paper.

It is absurd to believe that the Legislatures could have the slightest influence on a State Bank under the present or the proposed constitution, even if all the Directors would be elected by the Legislature.

A State Bank will under these two types of constitution always be under the decisive influence of the Governor General and the Secretary of State.

It remains now to elucidate the position under the Shareholders Scheme.

The example as regards the currency expansion may be taken up again.

If the elected Directors start a policy of expansion and give written instructions to the Governor to carry out such a policy up to the next Board Meeting and the Directors will find that the Governor has *not* carried out the instructions, they will have strong weapons to enforce their policy.

First of all, the elected Directors can convene immediately a general meeting where a strong protestation against the policy of the Governor can take place and made public throughout the country.*

Secondly, any shareholder can file a suit against the management of the Bank for not having carried out the decision of the majority of the Directors and thereby having caused damages to the Bank. It should, however not be forgotten that an expansion of currency against securities brings a profit to the Bank by an increase of the interest bearing assets. This aspect enables any shareholder to file a suit and it may be added that eminent authorities on Company Law, as well as on Constitutional Law, have expressed their opinion that there cannot be the slightest doubt that in such a case a High Court or the Privy Council will decide in favour of the shareholders.

*It may be remembered that the Directors of a State Bank would have no similar publicity at all.

From a legal point of view the Judges could not possibly enter into an examination of the general economic aspects of an expansion or contraction of currency and would have to investigate only whether the Governor by not carrying out the decisions of the majority of the Directors has lowered the possible income of the Bank.

In view of the above reasoning, it seems to be clear that only a Shareholders Bank can safeguard the national interests, *if* the shareholders *will* take an active interest, whereas a State Bank will solely be in the hands of the executive.

*A similar suit could naturally not be filed in case of contraction of currency.

CHAPTER V.

GENERAL CONCLUSIONS.

A birds-eye view of the possible working of the proposed Reserve Bank has been attempted.

It remains now to reply to the question under what circumstances could the operations of the Reserve Bank be described as "successful" ?

If the Bank is operating smoothly and if it is also evident that the Management take an active interest in the general economic welfare of the country and also carries out such distinct actions as prove that the Management is in fact trying its best to use its power for the benefit of the masses, under such circumstances the Bank may be said to be successful.

Roughly speaking 3 to 4 years at least will have to pass before such a judgment can be passed and during this initial period it would not be wise to disturb the Governors or to oppose them at the general meetings. The Shareholders Scheme proposed in the Bill gives enormous powers and possibilities to the shareholders and later on to the elected Directors to force a change of policy or to create a complete deadlock. In view of this enormous power it is felt that the only reasonable policy as regards the shareholders for the first few years is to :—

"*Wait and see*".

It should also be considered, that Governor will be well aware of his rather weak position and will surely try his best in order to eliminate beforehand every chance of a collision with the shareholders or the elected Directors.

Summing up the consequences of the analysis of the Bill three points may be emphasised :—

1. The Bill should be so amended as to suit the requirements of economic evolution better than the actual propositions. A few changes in such a direction have been recommended. (See, "Summary of recommendations, page 172).
2. The Governors shall try their best to conduct the business of the Bank so as to ensure the best possible results as regards the welfare of the nation as a whole.
3. The shareholders should give a fair chance to the management for at least three to four years in order to enable the Governors to prove that they are actively engaged to promote the economic welfare of the country.

Should it, however, become evident after say four years that the management is just carrying on without any regard for the promotion of general economic welfare, it will be the foremost duty of the shareholders and the elected Directors to oppose the policy of the Governor and if a suitable change will not be achieved, to create a complete deadlock.

If a deadlock has been arrived at, negotiations may be taken up to find a new Governor, and to start afresh on revised grounds.

Looking into the future, it is however, hoped that in case of difficulties suitable negotiations will be taken up beforehand and that every effort will be undertaken by both parties to secure an undisturbed success of the Bank.

CHAPTER VI.

SUMMARY OF RECOMMENDATIONS.

PART II.

1. Sub-clause (1) of clause 50 should be so amended as to authorise the Local Boards to enquire into the nationality of the shareholders of such companies as hold shares in the Reserve Bank. (Page 93).
2. The Act should provide suitable powers to the Central Board to forfeit a share when it is found that the same is held by a company registered under the Indian Companies Act, the share majority of which is held by foreigners. (Page 54).
3. Considering Indian conditions an age limit as regards Directors may be fixed at 60 years. The same age limit shall also apply to the Members of the Local Boards. (Page 56).
4. The omission of para (*b*) of sub-clause 1 of clause 10 is suggested. (Page 57).
5. The majority of Directors (7) should have the power to convene a meeting of the Central Board. (Page 60).
6. The Reserve Bank should have a perambulatory Head Office. (Page 60).
7. The last four words (.....“and any other persons,”) of sub-clause (1) of clause 17 should be omitted. (Page 65)
8. It should be reconsidered whether apart from scheduled banks, “approved persons” should also be granted the privilege of buying from and selling sterling to the Reserve Bank directly, (sub-clause 3 of clause 17). (Page 66.).

9. It should be made clear whether the Reserve Bank should keep sterling balances with commercial banks in sterling standard countries or only with the Central Banks of such countries, (sub-clause 3 and 13 of clause 17). (Page 67).

10. It should be stated whether loans on the security of sterling or sterling bills can be granted to "approved persons" too or only to scheduled banks para (*d*) of subclause (4) of clause (17). (Page 70).

11. A remark should be included at the end of clause 18 expressing the desire that the Reserve Bank should only do business with private clients in case of emergency and that all accounts which come into being in connection with emergency cases (open market operations) should be liquidated as soon as possible. (Page 73).

12. If very strong reasons cannot be advanced, the Reserve Bank should not be authorised to borrow in India. (Sub-clause 14 of clause 17). (Page 76).

13. Sub-clause (2) of clause 26 should be omitted if exceptionally convincing reasons are not given. (Page 81).

14. The following words should be inserted after the word "amount" in sub-clause (1) of clause 33 :—
".....(amount), *calculated on the basis of the purchase price*". (Page 82).

15. Rupee securities in the Assets of the Issue Department should be valued at "purchase price" and not at the "market rate" as proposed in the Bill, (Sub-clause (4) of clause 33). (Page 85).

16 The word "its" should be substituted for "his" in the last but one line of sub-clause (2) of clause 36. (Page 86).

17. The ratio of external assets should be reduced to 25% or abolished altogether according to the recommendation of Sir Henry Strakosch, and it should be left to the management to decide the necessary ratio according to varying circumstances. (Page 107).
18. The upper limit of Government of India rupee securities in the assets of the Issue Department should remain unchanged at the present figure of 100 crores of rupees. (Page 107).
19. The *ad hocs* in the Reserve should be replaced by marketable securities. The Government of India should issue a new long term loan which shall be taken over entirely by the Reserve Bank in replacement of *ad hocs*. (Page 102).
20. It may be considered whether documentary evidence should not be required in order to prove the bonafide status of bills of exchange or promissory notes as in the U. S. A. (Page 118).
21. The discount rate of the Reserve Bank should be considerably lower than the advance rate. (Page 121).
22. The banking structure of the country, *i.e.*, joint stock banks, co-operative organisations and indigenous bankers, should be so linked up that bills may flow from all possible sources to the Reserve Bank. (Page 125).
23. Produce merchants should draw on the scheduled banks. Such drafts accepted by the scheduled banks could be rediscounted by the Reserve Bank and the proceeds would serve for financing the marketing of crops. (Page 134).

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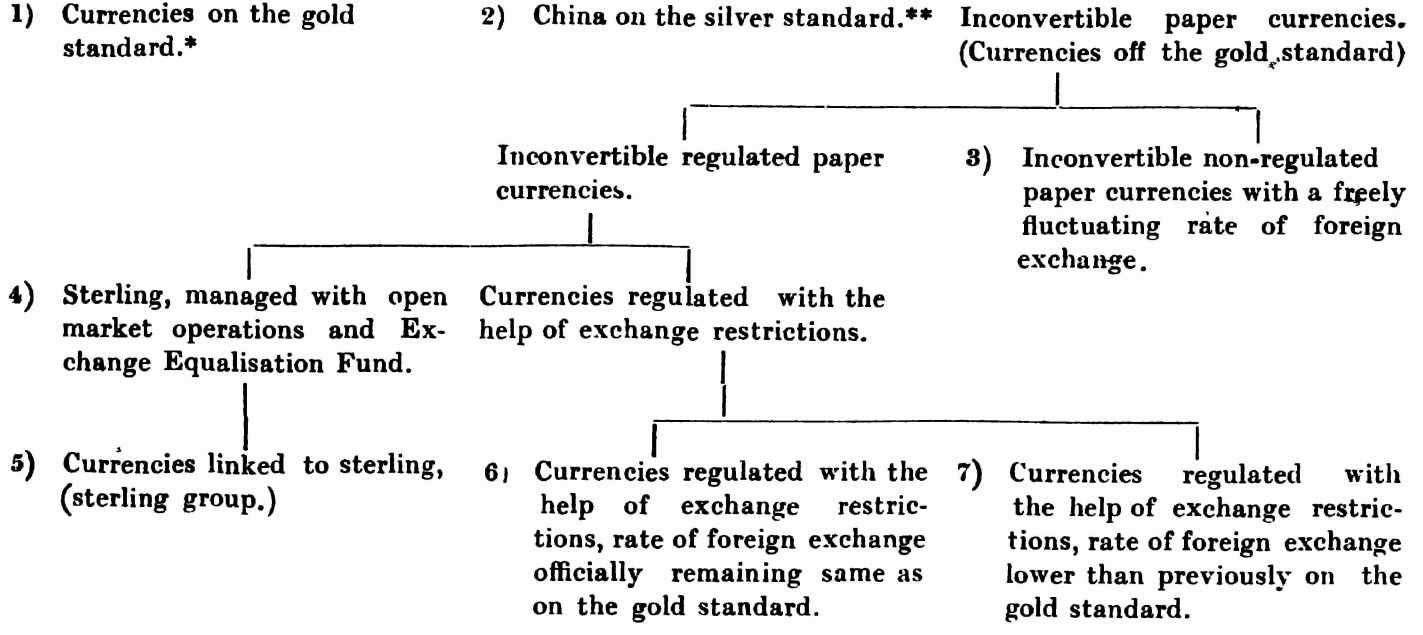
THE WORLD CURRENCY POSITION IN 1933.



*The respective countries are enumerated over leaf.

**The silver problem is not touched throughout this book. As expressed, the authors believe that there is not much chance in the near future of a restoration of the gold standard and still less of that of a silver currency or bimetallism.

1) France
Belgium
Netherland
Switzerland
Italy
Poland

2) China

3) Finland
Guatemala
Mexico
Palestine
Persia
Salvador
Siam
Venezuela
U. S. A.

4) Great Britain

5) Canada
Australia
New Zealand
South Africa
British India
Egypt
Norway
Sweden
Portugal
Persia

6) Germany
Bulgaria
Esthonia
Hungary
Latvia
Rumania
Czechoslovakia

7) Argentina
Austria
Bolivia
Brazil
Chili
Colombia
Costa-Rica
Denmark
Equador
Spain
Greece
Japan
Nicaragua
Paraguay
Turkey
Russia
Uruguay
Yougoslavia

APPENDIX.

THE RESERVE BANK OF INDIA BILL, 1933.

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THE SCHEDULES.

A

BILL

To

Constitute a Reserve Bank of India.

Whereas it is expedient to constitute a Reserve Bank for India to regulate the issue of Bank notes and the keeping of reserves with a view to securing monetary stability in British India, and generally to make provisions for matters incidental thereto;

And whereas in the present disorganisation of the monetary systems of the world it is not possible to determine what will be suitable as a permanent basis for the Indian monetary system;

But whereas it is expedient to make temporary provision on the basis of the existing monetary system, and to leave the question of the monetary standard best suited to India to be considered when the international monetary position has become sufficiently clear and stable to make it possible to frame permanent measures;

It is hereby enacted as follows:—

CHAPTER I.

PRELIMINARY.

Short title, extent, commencement and duration.

1. (*1*) This Act may be called the Reserve Bank of India Act, 1933.

(*2*) It extends to the whole of British India, including British Baluchistan and the Sonthal Parganas.

(*3*) This section shall come into force at once, and the remaining provisions of this Act shall come into force on such date or dates as the Governor General in Council may, by notification in the Gazette of India, appoint.

(*4*) Chapter III shall remain in force for a period of twenty-five years and thereafter until repealed.

Definitions.

2. In this Act, unless there is anything repugnant in the subject or context,—

(*a*) "the Bank" means the Reserve Bank of India constituted by this Act;

(*b*) "bank note" means paper money issued by the Bank;

(*c*) "the Central Board" means the Central Board of Directors of the Bank;

(*d*) "sterling standard country" means the United Kingdom and any country, other than British India, in which any person is entitled by law to obtain sterling on demand from the principal currency authority of that country, on payment at a fixed rate in the legal tender currency of that country;

(*e*) "provincial co-operative bank" means any society which is registered or deemed to be registered under the Co-operative Societies Act, 1912, or any other law for the time being in force in British India relating to co-operative societies and the sole business and object of which is the financing of the other societies in a province which are or are deemed to be so registered;

(*f*) "rupee coin" means silver rupees which are legal tender under the provisions of the Indian Coinage Act, 1906; and

(*g*) "scheduled bank" means a bank included in the Second Schedule.

CHAPTER II.

INCORPORATION, SHARE CAPITAL, MANAGEMENT AND BUSINESS.

Establishment and incorporation of Reserve Bank.

3. (*1*) A Bank to be called the Reserve Bank of India shall be constituted for the purposes of taking over the management of the currency from the Governor General in Council and of carrying on the business of banking in accordance with the provisions of this Act.

(*2*) The Bank shall be a body corporate by the name of the Reserve Bank of India, having perpetual succession and a common seal, and shall by the said name sue and be sued.

Share capital, share registers and shareholders.

4. (*1*) The original share capital of the Bank shall be five crores of rupees divided into shares of five hundred rupees each, which shall be fully paid up.

(*2*) Separate registers of shareholders shall be maintained at Bombay, Calcutta, Delhi, Madras and Rangoon, and a separate issue of shares shall be made in each of the areas served by those registers, as defined in the First Schedule, and shares shall be transferable from one register to another,

(3) A shareholder shall be qualified to be registered as such in any area in which he is ordinarily resident or has his principal place of business in India, but no person shall be registered as a shareholder in more than one register; and no person who is not :—

(*a*) domiciled in India, or

(*b*) a British subject ordinarily resident in India, or

(*c*) a company registered under the Indian Companies Act, 1913, or a society registered under the Co-operative Societies Act, 1912, or a scheduled bank, or a corporation or company incorporated by or under an Act of Parliament or any law for the time being in force in any of his Majesty's dominions and having a branch in British India,

shall be registered as a shareholder or be entitled to payment of any dividend on any share.

(4) The Central Board may, at its discretion, without giving any reason, decline to allot shares to any applicant or to register any transfer of shares.

(5) The nominal value of the shares originally assigned to the various registers shall be as follows, namely :—

(*a*) to the Bombay register—one hundred and sixty-five lakhs of rupees ;
(*b*) to the Calcutta register—one hundered and sixty-five lakhs of rupees;
(*c*) to the Delhi register—eighty lakhs of rupees ;
(*d*) to the Madras register—fifty lakhs of rupees ;
(*e*) to the Rangoon register—forty lakhs of rupees ;

Provided that, in the event of the shares assigned to any register not being fully taken up at the first allotment, the Central Board may, with the previous sanction of the Governer General in Council, transfer a portion of such shares from that register to another.

(6) In allotting the shares assigned to a register, the Central Board shall, in the first instance, allot two shares to each qualified applicant who has applied for two or more shares; and if the number of such applicants is greater than half the total number of shares assigned to the register, shall determine by lot the applicants to whom the shares shall be allotted.

If the number of such applicants is less than half the number of shares assigned to the register, the Central Board shall allot the remaining shares to applicants who have applied for more shares than two; and if the number of extra shares so applied for exceeds the number of shares so to be allotted, the Central Board shall allot them among the various applicants in such manner

as it may deem fair and equitable, having regard to the desirability of distributing the shares and the voting rights attached to them as widely as possible.

If any shares still remain unallotted, the Central Board shall allot them to applicants who have applied for one share only; and if the number of shares so applied for exceeds the number of shares to be so allotted, the Central Board shall determine by lot the applicants to whom the shares shall be allotted.

If, after all applications have been met in accordance with the provisions of this sub section, any shares remain unallotted, they shall, notwithstanding anything contained in this section, be allotted to and taken up by Government, and shall be sold by the Governor General in Council, at not less than par, as soon as may be.

The Governor General in Council shall have no right to exercise any vote under this Act by reason of any shares so allotted to him.

Increase and reduction of share capital.

5. (*1*) The share capital of the Bank may be increased by the Central Board with the previous sanction of the Governor General in Council.

(*2*) Every such increase shall be fully paid up, and the areas to which such further shares shall be allotted and the price at which they may be issued shall be fixed by the Central Board with the like sanction.

(*3*) The Central Board may determine the manner in which any increase of share capital shall be effected.

(*4*) The share capital of the Bank may be reduced by the Central Board, with the previous sanction of the Governor General in Council, to such extent and in such manner as may be determined by the Bank in general meeting.

Head Office, branches and agencies.

6. The Head Office of the Bank shall be established in Bombay, and the Bank shall, as soon as may be, establish branches in Calcutta, Delhi, Madras and Rangoon, and may establish branches or agencies in any other place in India or, with the previous sanction of the Governor General in Council, elsewhere.

Management.

7. The general superintendence of the affairs and business of the Bank shall be entrusted to a Central Board of Directors which may exercise all powers and do all acts and things which may be exercised or done by the Bank and are not by this Act expressly directed or required to be done by the Bank in general meeting.

Composition of the Central Board, and term of office of Directors.

8. (*1*) The Central Board shall consist of the following Directors, namely:—

(*a*) a Governor and one Deputy Governor or two Deputy Governors, to be appointed by the Governor General in Council after consideration of the recommendations made by the Board in that behalf;

(*b*) four Directors to be nominated by the Governor General in Council;

(*c*) eight Directors to be elected on behalf of the shareholders on the various registers, in the manner provided in section 9 and in the following numbers, namely:—

(*i*) for the Bombay register—two Directors;
(*ii*) for the Calcutta register—two Directors;
(*iii*) for the Delhi register—two Directors;
(*iv*) for the Madras register—one Director;
(*v*) for the Rangoon register—one Director; and

(*d*) one government official to be nominated by the Governor General in Council.

(*2*) The Governor and Deputy Governors shall devote their whole time to the affairs of the Bank, and shall receive such salaries and allowances as may be determined by the Central Board, subject to any minimum prescribed by the Governor General in Council.

(*3*) A Deputy Governor and the Director nominated under clause (*d*) of sub-section (*1*) may attend any meeting of the Central Board and take part in its deliberations but shall not be entitled to vote:

Provided that when the Governor is absent a Deputy Governor authorised by him in this behalf in writing may vote for him.

(*4*) The Governor and a Deputy Governor shall hold office for such term not exceeding five years as the Governor General in Council may fix when appointing them, and shall be eligible for re-appointment.

A Director elected under clause (*c*) of sub-section (*1*) shall hold office for five years, or thereafter until his successor shall have been duly elected, and, subject to the provisions of section 10, shall be eligible for re-election.

The Directors nominated under clause (*b*) and clause (*d*) of sub-section (*1*) shall hold office during the pleasure of the Governor General in Council.

(*5*) No act or proceeding of the Board shall be questioned on the ground merely of the existence of any vacancy in, or any defect in the constitution of the Board.

Local Boards, their constitution and functions.

9. (*1*) A Local Board shall be constituted for each of the five areas specified in the First Schedule, and shall consist of—

(*a*) five members elected from amongst themselves by the shareholders who are registered on the Register for that area and are qualified to vote, and

(*b*) not more than three members nominated by the Central Board, who may be nominated at any time.

(*2*) At an election of members of a Local Board for any area, any shareholder who has been registered on the Register for that area, for a period of not less than six months ending with the date of the meeting, as holding two shares shall have one vote, and each shareholder so registered as having more than two shares shall have one vote for each two shares, but subject to a maximum of ten votes.

(*3*) The members of a Local Board shall hold office until they vacate it under sub-section (5) and, subject to the provisions of section 10, shall be eligible for re-election or re-nomination, as the case may be.

(*4*) At any time within three months of the day on which the Directors representing the shareholders on any register are due to retire under the provisions of this Act, the Central Board shall direct an election to be held of members of the Local Board concerned, and such election shall be held forthwith, and the names of the persons elected shall be notified to the Central Board.

(*5*) On such notification, the Central Board shall proceed to make any nominations permitted by clause (*b*) of sub-section (*1*) it may then decide to make, and shall fix the date on which the outgoing members of the Local Board shall vacate office, and the incoming members shall be deemed to have assumed office on that date.

(*6*) The elected members of a Local Board shall, as soon as may be after they have been elected, elect from amongst themselves one or two persons, as the case may be, to be Directors representing the shareholders on the Register for the area for which the Board is constituted.

(*7*) A Local Board shall advise the Central Board on such matters as may be generally or specifically referred to it and shall perform such duties as the Board may, by regulations, delegate to it.

Qualifications and disqualifications of Directors and members of Local Boards.

10. (*1*) No person may be a Director or a member of a Local Board who is not or has not at some time been

(*a*) engaged in the direction of agricultural, commercial, financial or industrial activities, or

(*b*) a director of any company as defined in clause (*2*) of section 2 of the Indian Companies Act, 1913, or of a corporation or company incorporated by or under any law for the time being in force in any place outside British India.

(2) No person may be a Director or a member of a Local Board who—

(*a*) is a government official or an official of a State in India, or

(*b*) is, or at any time has been, adjudicated an insolvent, or

(*c*) is an officer or employee of any bank, or

(*d*) is a director of any bank, other than a registered society as defined in clause (*e*) of section 2 of the Co-operative Societies Act, 1912:

Provided that an official of a State in India (not being a government official on deputation in the State) may be nominated as a Director or as a member of a Local Board.

(3) Nothing in this section shall apply to the Governor, or to a Deputy Governor or to the Director nominated under clause (*d*) of sub-section (*1*) of section 8.

Removal from and vacation of office.

11. (*1*) The Governor General in Council may remove from office the Governor, or a Deputy Governor or any nominated or elected Director:—

Provided that in the case of an elected Director this power shall be exercised only on a resolution passed by the Central Board in that behalf by a majority consisting of not less than nine Directors.

(*2*) A Director nominated or elected under clause (*b*) or clause (*c*) of section 8, and any member of a Local Board shall cease to hold office if, at any time after six months from the date of his nomination or election, or eighteen months from the commencement of this Act, whichever is later, he is not registered as a holder of unencumbered shares of the Bank of a nominal value of not less than ten thousand rupees, or if he ceases to hold unencumbered shares of that value.

(*3*) The Governor General in Council may remove from office any Director, and the Central Board may remove from office any member of a Local Board, if such Director or member becomes subject to any of the disqualifications specified in sub-section (*2*) of section 10.

(*4*) The appointment, nomination or election as Director or member of a Local Board of any person who is a member of the Indian Legislature or of a local Legislature shall be void, unless, within one month of the date of his appointment, nomination or election, he ceases to be such member, and, if any Director or member of a Local Board is elected or nominated as a member of

any such Legislature, he shall cease to be a Director or member of the Local Board as from the date of such election or nomination, as the case may be.

(5) A Director may resign his office to the Governor General in Council, and a member of a Local Board may resign his office to the Central Board, and on the acceptance of the resignation the office shall become vacant.

Casual vacancies and absences.

12. (*1*) If the Governor or a Deputy Governor by infirmity or otherwise is rendered incapable of executing his duties or is absent on leave or otherwise in circumstances not involving the vacation of his appointment, the Governor General in Council may appoint another person to officiate for him, and such person may, notwithstanding anything contained in clause (*c*) of sub-section (2) of section 10, be an officer of the Bank.

(2) If an elected Director is for any reason unable to attend a particular meeting of the Central Board, the elected members of the Local Board of the area which he represents may elect one of their number to take his place, and for the purposes of that meeting the substitute so elected shall have all the powers of the absent Director.

(3) A casual vacancy in the office of a Director, other than the vacancies provided for in sub-section (*1*), shall be filled in the manner in which, and by the authority by whom, the nomination or election of the Director vacating office was made; and the Director so nominated or elected shall hold office for the unexpired portion of the term of his predecessor.

(*4*) Where any casual vacancy in the office of any member of a Local Board occurs, the Central Board may nominate thereto any qualified person recommended by the Local Board, and the person so nominated shall hold office for the unexpired period of the term of his predecessor.

Meetings of the Central Board.

13. (*1*) Meetings of the Central Board shall be convened by the Governor at least six times in each year and at least once in each quarter. Meetings shall ordinarily be held in Bombay, but at least two meetings of the Central Board shall be held in Calcutta in each year.

(*2*) The Governor, or in his absence the Deputy Governor authorised by the Governor under the proviso to sub-section (*3*) of section 8 to vote for him, shall preside at meetings of the Central Board, and, in the event of an equality of votes, shall have a second or casting vote.

General meetings.

14. (*1*) A general meeting (hereinafter in this Act referred to as the annual general meeting) shall be held annually at Bombay within six weeks from the date on which the annual accounts of the Bank are closed, and a general meeting may be convened by the Central Board at any other time.

(*2*) Any shareholder shall be entitled to attend at any general meeting, and each shareholder who has been registered on any Register, for a period of not less than six months ending with the date of the meeting, as holding two shares shall have one vote, and each shareholder so registered as having more than two shares shall have one vote for each two shares, but subject to a maximum of ten votes; and such votes may be exercised by proxy.

First constitution of the Central Board.

15. (*1*) The following provisions shall apply to the first constitution of the Central Board, and, notwithstanding anything contained in section 8, the Central Board as constituted in accordance therewith shall be deemed to be duly constituted in accordance with this Act.

(*2*) The first Governor and the first Deputy Governor or Deputy Governors shall be appointed by the Governor General in Council on his own initiative, and shall receive such salaries and allowances as he may determine.

(*3*) The first eight Directors representing the shareholders on the various Registers shall be nominated by the Governor General in Council after consultation with the Local Governments concerned.

(*4*) A director so nominated to represent shareholders on the Bombay or Calcutta Register shall hold office for two years, and Director so nominated to represent shareholders on the Delhi, Madras or Rangoon Register shall hold office for four years, or thereafter until his successor shall have been duly elected.

First constitution of Local Boards.

16. As soon as may be after the commencement of this Act, the Central Board shall direct elections to be held and may make nominations, in order to constitute Local Boards in accordance with the provisions of section 9, and the members of such Local Boards shall hold office up to the date fixed under sub-section (*5*) of section 9, but shall not exercise any right under sub-section (6) of that section.

Business which the Bank may transact.

17. The Bank shall be authorised to carry on and transact the several kinds of business hereinafter specified, namely:—

(*1*) The accepting of money on deposit without interest from, and the collection of money for, the Secretary of State in Council, the Governor General in Council, Local Governments, States in India, banks and any other persons;

(*2*) (*a*) the purchase, sale and rediscount of bills of exchange and promissory notes, drawn and payable in India and arising out of *bona fide* commercial or trade transactions, bearing two or more good signatures, one of which shall be that of a scheduled bank, and maturing within ninety days from the date of such purchase or rediscount, exclusive of days of grace;

(*b*) the purchase, sale and rediscount of bills of exchange and promissory notes, drawn and payable in India and bearing two or more good signatures, one of which shall be that of a scheduled bank, or a provincial co-operative bank, and drawn or issued for the purpose of financing seasonal agricultural operations or the marketing of crops, and maturing within six months from the date of such purchase or rediscount, exclusive of days of grace : provided that the total face value of bills or notes so purchased or rediscounted shall not at any time exceed one-fourth of the total face value of all bills and notes purchased or rediscounted by the Bank up to that time ;

(*c*) the purchase, sale and rediscount of bills of exchange and promissory notes drawn and payable in India and bearing the signature of a scheduled bank, and issued or drawn for the purpose of holding or trading in securities of the Government of India or a Local Government, or such securities of States in India as may be specified in this behalf by the Governor General in Council on the recommendation of the Central Board, and maturing within ninety days from the date of such purchase or rediscount, exclusive of days of grace ;

(*3*) the purchase from and sale to scheduled banks and persons approved by the Central Board, in amounts of not less than the equivalent of one lakh of rupees, of the currencies of such sterling standard countries as may be specified in this behalf by the Governor General in Council by notification in the Gazette of India, and of bills of exchange (including treasury bills) drawn in or on any place in any such country, and maturing within ninety days from the date of such purchase, exclusive of days of grace ; and the keeping of balances with banks in such countries ;

(*4*) the making of loans and advances, repayable on demand or on the expiry of fixed periods not exceeding ninety days, against the security of—

(*a*) stocks, funds and securities (other than immovable property) in which a trustee is authorised to invest trust money by any Act of Parliament or by any law for the time being in force in British India ;

(*b*) gold coin or bullion or documents of title to the same ;

(*c*) such bills of exchange and promissory notes as are eligible for purchase or rediscount by the Bank : provided that the total of the loans and advances against such securities as are referred to in sub-clause (*b*) of clause (*2*) shall not at any time exceed one-fourth of the total loans and advances made by the Bank up to that time ;

(*d*) such bills of exchange as are eligible for purchase by the Bank under clause (*3*) ;

(*e*) promissory notes of any scheduled bank or a provincial co-operative bank, supported by documents evidencing title to goods which have been transferred, assigned, hypothecated or pledged to any such bank as security for a cash credit granted for *bona fide* commercial or trade transactions, or for the purpose of financing seasonal agricultural operations or the marketing of crops : provided that no loan or advance shall be made on the security of any promissory note such as is referred to in this sub-clause after the expiry of five years from the date on which this section comes into force ;

(*5*) the making of advances to the Governor General in Council repayable in each case not later than three months after the close of the financial year in respect of which the advance has been made ;

(6) the issue of demand drafts and the making, issue and circulation of bank post bills made payable on its own branches ;

(*7*) the purchase and sale of securities, maturing within five years from the date of such purchase, of the Government of any sterling standard country specified in this behalf by the Governor General in Council by notification in the Gazette of India ;

(*8*) the purchase and sale of securities of the Government of India of any maturity, or of a Local Government or of a local authority in British India maturing within ten years from the date of purchase, or of such securities of States in India of like maturity as may be specified in this behalf by the Governor General in Council on the recommendation of the Central Board : provided that the amount of such securities held at any time in the Banking Department shall be so regulated that—

(*a*) the total value of such securities shall not exceed the aggregate amount of the share capital of the Bank, the Reserve Fund and two-fifths of the liabilities of the Banking Department in respect of deposits ;

(*b*) the value of such securities maturing after six months shall not exceed the aggregate amount of the share capital of the Bank, the Reserve Fund and one-fifth of the liabilities of the Banking Department in respect of deposits ;

(*c*) the value of such securities maturing after one year shall not exceed the aggregate amount of the share capital of the Bank, the Reserve Fund and one-tenth of the liabilities of the Banking Department in respect of deposits ; and

(*d*) the value of such securities maturing after ten years shall not exceed the aggregate amount of the share capital of the Bank and the Reserve Fund ;

(*9*) the custody of monies, securities and other articles of value, and the collection of the proceeds, whether principal, interest or dividends, of any such securities;

(*10*) the sale and realisation of all property, whether movable or immovable, which may in any way come into the possession of the Bank in satisfaction, or part satisfaction, of any of its claims;

(*11*) the acting as agent for the Secretary of State in Council, the Governor General in Council or any Local Government or State in India in the transaction of any of the following kinds of business, namely:—

(*a*) the purchase and sale of gold or silver;

(*b*) the purchase, sale, transfer and custody of bills of exchange, securities or shares in any company;

(*c*) the collection of the proceeds, whether principal, interest or dividends, of any securities or shares;

(*d*) the remittance of such proceeds, at the risk of the principal, by bills of exchange, payable either in India or elsewhere;

(*e*) the management of public debt;

(*12*) the purchase and sale of gold coin and bullion;

(*13*) the opening of an account with, and the acting as agent or correspondent of, any other bank which is the principal currency authority of a sterling standard country under the law for the time being in force in that country;

(*14*) the borrowing of money for a period not exceeding one month for the purposes of the business of the Bank, and the giving of security for money so borrowed:

Provided that no money shall be borrowed under this clause from any person in India other than a scheduled bank, or from any person outside India other than a bank which is the principal currency authority of any country under the law for the time being in force in that country:

Provided further that the total amount of such borrowings from persons in India shall not at any time exceed the amount of the share capital of the Bank;

(*15*) the making and issue of bank notes subject to the provisions of this Act; and

(*16*) generally, the doing of all such matters and things as may be incidental to or consequential upon the exercise of its powers or the discharge of its duties under this Act.

Power of direct discount.

18. When, in the opinion of the Central Board, or, where the powers and functions of the Central Board under this section have been delegated to the Governor, in the opinion of the Governor, it is necessary or expedient that action should be taken under this section for the purpose of regulating credit in the interests of Indian trade, commerce, industry and agriculture, the Bank may, notwithstanding any limitation contained in sub-clauses (*a*) and (*b*) of clause (2) of section 17, purchase, sell or discount any bills of exchange or promissory notes drawn and payable in India and arising out of *bona fide* commercial or trade transactions, bearing two or more good signatures and maturing within ninety days from the date of such purchase or discount, exclusive of days of grace.

Business which the Bank may not transact.

19. Save as otherwise provided in sections 17, 18 and 43, the Bank may not—

(*1*) engage in trade or otherwise have a direct interest in any commercial, industrial, or other undertaking, except such interest as it may in any way acquire in the course of the satisfaction of any of its claims: provided that all such interests shall be disposed of at the earliest possible moment;

(*2*) purchase its own shares or the shares of any other bank or of any company, or grant loans upon the security of any such shares;

(*3*) advance money on mortgage of, or otherwise on the security of, immovable property or documents of title relating thereto, or become the owner of immovable property, except so far as is neeessary for its own business premises and residences for its officers and servants;

(*4*) make unsecured loans or advances;

(*5*) draw or accept bills payable otherwise than on demand;

(*6*) allow interest on deposits or current accounts.

CHAPTER III.

CENTRAL BANKING FUNCTIONS.

Obligation of the Bank to transact Government business.

20. The Bank shall undertake to accept monies for account of the Secretary of State in Council and the Governor General in Council and such Local Governments as may have the custody and management of their own provincial revenues, and to make payments up to the amount standing to the credit of their accounts respectively, and to carry out their exchange, remittance and other banking operations, including the management of the public debt, on such conditions as may be agreed upon.

Bank to have the right to transact Government business in India.

21. (*1*) The Governor General in Council and such Local Governments as may have the custody and management of their own provincial revenues shall undertake to entrust the Bank, on such conditions as may be agreed upon, with all their money, remittance, exchange and banking transactions in India and, in particular, to deposit free of interest all their cash balances with the Bank :

Provided that nothing in this sub-section shall prevent the Governor General in Council or any Local Government from carrying on money transactions at Government treasuries or sub-treasuries at places where the Bank has no branches or agencies. and the Governor General in Council and Local Governments may hold at such treasuries and sub-treasuries such balances as they may require.

(*2*) The Governor General in Council and each Local Government shall undertake to entrust the Bank, on such conditions as may be agreed upon, with the management of the public debt and with the issue of any new loans in India.

Right to issue bank notes.

22. (*1*) The Bank shall have the sole right to issue paper money in British India, and may, for a period of one year from the date on which this Chapter comes into force, issue currency notes of the Government of India supplied to it by the Governor General in Council, and the provisions of this Act applicable to bank notes shall, unless a contrary intention appears, apply to all currency notes of the Government of India issued either by the Governor General in Council or by the Bank in like manner as if such currency notes were bank notes, and references in this Act to bank notes shall be construed accordingly.

(*2*) On and from the aforesaid date the Governor General in Council shall not issue any currency notes or any other kind of paper money.

Issue Department.

23. (*1*) The issue of bank notes shall be conducted by the Bank in an Issue Department which shall be separated and kept wholly distinct from the Banking Department, and the assets of the Issue Department shall not be subject to any liability other than the liabilities of the Issue Department as hereinafter defined in section 34.

(2) The Issue Department shall not issue bank notes to the Banking Department or to any other person except in exchange for other bank notes or for such coin, bullion or securities as are permitted by this Act to form part of the Reserve.

Denominations of notes.

24. Bank notes shall be of the denominational values of five rupees, ten rupees, fifty rupees, one hundred rupees, five hundred rupees, one thousand rupees and ten thousand rupees, and of such other denominational values, if any, as may be directed by the Governor General in Council.

Form of bank notes.

25. The design, form and material of bank notes shall be such as may be approved by the Governor General in Council.

Legal tender character of notes.

26 (*1*) Subject to the provisions of sub-section (2), every bank note shall be legal tender at any place in British India in payment or on account for the amount expressed therein, and shall be guaranteed by the Governor General in Council.

(2) The Governor General in Council may, by notification in the Gazette of India, declare that, with effect from such date as may be specified in the notification, any series of bank notes of any denomination shall cease to be legal tender save at an office or agency of the Bank.

Re-issue of notes.

27. Any bank note re-issued from any office of the Bank shall be sterilized and disinfected before re-issue, and the Bank shall not re-issue bank notes which are torn, defaced or excessively soiled.

Recovery of notes lost, stolen, mutilated or imperfect.

28. Notwithstanding anything contained in any enactment or rule of law to the contrary, no person shall of right be entitled to recover from the Governor General in Council or the Bank the value of any lost, stolen, mutilated or imperfect currency note of the Government of India or bank note :

Provided that the Bank may, with the previous sanction of the Governor General in Council, prescribe the circumstances in and the conditions and limitations subject to which the value of such currency notes or bank notes may be refunded as of grace.

Bank exempt from stamp duty on bank notes.

29. The Bank shall not be liable to the payment of any stamp duty under the Indian Stamp Act, 1899, in respect of bank notes issued by it.

Powers of Government in respect of note issue and assets of the Bank in certain circumstances.

30. If at any time the Bank fails to comply with any provision of this Chapter or with any other provision of this Act, the Governor General in Council may, by notification in the Gazette of India, declare that the Bank has forfeited the right of note issue, and shall thereupon take over the liabilities of the Issue Department, together with such portion of the assets of the Bank as is required to meet such liabilities, and thereafter the business of the Issue Department shall be carried on in the manner prescribed by this Act by such agency as the Governor General in Council may determine.

Issue of demand bills and notes.

31. No person in British India other than the Bank or, as expressly authorised by this Act, the Governor General in Council shall draw, accept, make or issue any bill of exchange, hundi, promissory note or engagement for the payment of money payable to bearer

on demand, or borrow, owe or take up any sum or sums of money on the bills, hundis or notes payable to bearer on demand of any such person :

Provided that cheques or drafts payable to bearer on demand or otherwise may be drawn on a person's account with a banker, shroff or agent.

Penalty.

32. (*1*) Any person contravening the provisions of section 31 shall, on conviction by a Presidency Magistrate or a Magistrate of the first class, be punishable with fine equal to the amount of the bill, hundi, note or engagement in respect whereof the offence is committed.

(*2*) No prosecution under this section shall be instituted except on complaint made by the Bank.

Assets of the Issue Department.

33. (*1*) The assets of the Issue Department shall consist of gold coin, gold bullion, securities of sterling standard countries, rupee coin and rupee securities to such aggregate amount as is not less than the total of the liabilities of the Issue Department as hereinafter defined.

(*2*) Of the total amount of the assets, not less than two-fifths shall consist of gold coin, gold bullion or securities of sterling standard countries :

Provided that the amount of gold coin and gold bullion shall not at any time be less than thirty-five crores of rupees in value.

(*3*) The remainder of the assets shall be held in rupee coin, Government of India rupee securities of any maturity and such bills of exchange and promissory notes drawn and payable in British India as are eligible for purchase by the Bank under sub-clause (*a*) or sub-clause (*b*) of clause (*2*) of section 17 or under section 18 :

Provided that the amount held in Government of India rupee securities shall not at any time exceed one-fourth of the total amount of the assets or fifty crores of rupees, whichever amount is less.

(*4*) For the purposes of this section, gold coin and gold bullion shall be valued at 8·47512 grains of fine gold per rupee, rupee coin shall be valued at its face value, and securities shall be valued at the market rate for the time being obtaining.

(*5*) Of the gold coin and gold bullion held as assets, not less than seventeen-twentieths shall be held in British India, and all gold coin and gold bullion held as assets shall be held in the custody of the Bank or its agencies :

Provided that gold belonging to the Bank which is in any other bank or in any mint or treasury or in transit may be reckoned as part of the assets.

(*6*) For the purposes of this section, the securities of a sterling standard country which may be held as part of the assets shall be securities of any of the

following kinds payable in the currency of any of such sterling standard countries as may be specified in this behalf by the Governor General in Council by notification in the Gazette of India, namely :—

(*a*) balances at the credit of the Issue Department with a bank which is the principal currency authority under the law for the time being in force of such country ;

(*b*) bills of exchange bearing two or more good signatures and drawn on and payable at a place in any such country and having a maturity not exceeding ninety days ;

(*c*) securities maturing within five years of the Government of any sterling standard country specified in this behalf by the Governor General in Council by notification in the Gazette of India :

Provided that, for a period of two years from the date on which this Chapter comes into force,—

(*i*) any of such last mentioned securities may be securities maturing after five years, and the Bank may, at any time before the expiry of that period, dispose of such securities notwithstanding anything contained in section 17, and

(*ii*) sterling securities of the Government of India may be held as part of the assets.

Liabilities of the Issue Department.

34. (*1*) The liabilities of the Issue Department shall be an amount equal to the total of the amount of the currency notes of the Government of India and bank notes for the time being in circulation.

(*2*) For the purposes of this section, any currency note of the Government of India or bank note which has not been presented for payment within forty years from the 1st day of April following the day of its issue shall be deemed not to be in circulation, and the value thereof shall, notwithstanding anything contained in sub-section (*2*) of section 23, be paid by the Issue Department to the Governor General in Council or the Banking Department, as the case may be ; but any such note, if subsequently presented for payment, shall be paid by the Banking Department, and any such payment in the case of a currency note of the Government of India shall be debited to the Governor General in Council

Initial assets and liabilities.

35. On the date on which this Chapter comes into force, the Issue Department shall take over from the Governor General in Council the liability for all the currency notes of the Government of India for the time being in circulation, and the Governor General in Council shall transfer to the Issue Department gold coin, gold bullion, securities

of sterling standard countries, rupee coin and rupee securities to such aggregate amount as is equal to the total of the amount of the liability so tranferred. The coin, bullion and securities shall be transferred in such proportion as to comply with the requirements of setcion 33;

Provided that the total amount of the gold coin, gold bullion and securities of sterling standard countries so transferred shall not be less than one-half of the whole amount transferred and that the amount of rupee coin so transferred shall not exceed fifty crores of rupees.

Method of dealing with fluctuations in rupee coin assets.

36. (1) After the close of any financial year in which the minimum amount of rupee coin held in the assets, as shown in any of the weekly accounts of the Issue Department for that year prescribed under sub-section (1) of section 49, is greater than fifty crores of rupees or one-tenth of the total amount of the assets as shown in that account, whichever may be the greater, the Bank may deliver to the Governor General in Council rupee coin up to the amount of such excess but not without his consent exceeding five crores of rupees, against payment of legal tender value in the form of bank notes gold or securities:

Provided that if the Bank so desires and if the amount of gold coin, gold bullion and securities of a sterling standard country in the assets does not at that time exceed one-half of the total assets, a proportion not exceeding two-fifths of such payment shall be in gold coin, gold bullion or such securities of a sterling standard country as may be held as part of the assets under sub-section (6) of section 33.

(2) After the close of any financial year in which the maximum amount of rupee coin held in the assets, as so shown, is less than five crores of rupees or one-tenth of the total amount of the assets, as so shown, whichever may be the greater, the Governor General in Council may deliver to the Bank rupee coin up to the amount of such deficiency, but not without his consent exceeding five crores of rupees, against payment of legal tender value.

Suspension of assets requirements.

37. (1) Notwithstanding anything containted in the foregoing provisions, the Bank may, with the previous sanction of the Governor General in Council, for periods not exceeding thirty days in the first instance, which may, with the like sanction, be extended from time to time by periods not exceeding fifteen days, hold as assets gold coin, gold bullion or securities of a sterling standard country of less aggregate amount than that required by sub-section (2) of section 33 and, whilst the holding is so reduced, the proviso to that sub-section shall cease to be operative.

(2) In respect of any period during which the holding of gold coin, gold bullion and securities of a sterling standard country is reduced under sub-section (1), the Bank shall pay to the Governor General in Council a tax upon the amount by which

such holding is reduced below the minimum prescribed by sub-section (2) of section 33 ; and such tax shall be payable at the bank rate for the time being in force, with an addition of one per cent. per annum when such holding exceeds thirty-two and a half per cent. of the total amount of the assets and of a further one and a half per cent. per annum in respect of every further decrease of two and a half per cent. or part of such decrease :

Provided that the tax shall not in any event be payable at a rate less than six per cent. per annum.

Obligations of Government and the Bank in respect of rupee coin.

38. The Governor General in Council shall undertake not to re-issue any rupee coin delivered under section 36 nor to put into circulation any new rupees, except through the Bank and as provided in that section ; and the Bank shall undertake not to dispose of rupee coin otherwise than for the purpose of circulation or by delivery to the Governor General in Council under that section.

Obligation to supply different forms of currency.

39. The Bank shall issue rupee coin on demand in exchange for currency notes of the Government of India, and shall issue currency notes or bank notes on demand in exchange for coin which is legal tender under the Indian Coinage Act, 1906, and it shall, in exchange for currency notes or bank notes of five rupees or upwards, supply currency notes or bank notes of lower value or rupees or other coins which are legal tender under the Indian Coinage Act, 1906, in such quantities as may, in the opinion of the Bank, be required for circulation ; and the Governor General in Council shall, subject to the provisions of section 36, supply such rupees or other coins to the Bank on demand. If the Governor General in Council at any time fails to discharge this duty, the Bank shall be released from its obligations to supply such coins to the public.

Obligation to sell sterling.

40. (1) The Bank shall sell, to any person who makes a demand in that behalf at its office in Bombay, Calcutta, Delhi, Madras or Rangoon and pays the purchase price in legal tender currency, sterling for immediate delivery in London, at a rate not below one shilling and five pence and forty-nine sixty-fourths of a penny for a rupee :

Provided that no person shall be entitled to demand to buy an amount of sterling less than ten thousand pounds.

Obligation to buy sterling.

41. The Bank shall buy, from any person who makes a demand in that behalf at its office in Bombay, Calcutta, Delhi, Madras or Rangoon, sterling for immediate delivery in London, at a rate not higher than one shilling and six pence and three-sixteenths of a penny for a rupee :

Provided that no person shall be entitled to demand to sell an amount of sterling less than ten thousand pounds.

Cash reserves of scheduled banks to be kept with the Bank.

42. (1) Every bank included in the Second Schedule shall maintain a balance with the Reserve Bank the amount of which shall at no time be less than seven and one-half per cent. of the daily average of the demand, and two and one-half per cent. of the daily average of the time liabilities of such bank in India.

(2) For the purposes of sub-section (1), daily average of the amounts of the demand and time liabilities of each scheduled bank shall be computed in respect of each period ending on the fifteenth and on the last day of each month.

(3) Every such bank shall send to the Governor General in Council and to the Bank a monthly return, signed by two responsible officers of such bank, showing—

(a) the amounts of its demand and time liabilities respectively in India,

(b) the total amount held in India in currency notes of the Government of India and bank notes,

(c) the amounts held in India in rupee coin and subsidiary coin respectively,

(d) the amounts of advances made and of bills discounted in India respectively, and

(e) the balance held at the Bank,

at the close of the month to which the return relates.

(4) Every such return shall be sent not later than fourteen days after the close of the month to which it relates, and shall state whether the bank has during that month maintained with the Reserve Bank the minimum balance required by sub-section (1).

(5) Any bank failing to comply with the provisions of sub-section (3) or sub-section (4) shall be liable, on application made by or on behalf of the Governor General in Council to the principal Civil Court having jurisdiction in a place where an office of the bank is situated, to a penalty of one hundred rupees for each day during which the failure continues.

(6) When it appears from any such monthly return or from a report of the Central Board that any scheduled bank has failed to maintain the minimum balance required by sub-section (1), the Governor General in Council may call for such further return, or make such inspection of the books and accounts of that bank, as may be necessary to ascertain the amount of the deficiency, if any, and the period during which it has continued; and a bank so in default shall be liable, on application made by or on behalf of the Governor General in Council to the principal Civil Court having jurisdiction in a place where an office of the bank is situated, to a penalty at a rate per annum which shall be three per cent. above the bank rate on the amount of the deficiency for each day during which

the default has continued, and shall be raised to five per cent. above the bank rate after the first seven days of the deficiency.

(*7*) The Governor General in Council shall, by notification in the Gazette of India, direct the inclusion in the Second Schedule of any company, not already so included, which carries on the business of banking in British India and which—

(*a*) is a company as defined in clause (*2*) of section 2 of the Indian Companies Act, 1913, or a corporation or company incorporated by or under any law in force in any place outside British India, and

(*b*) has a paid up capital and reserves of an aggregate value of not less than three lakhs of rupees;

and shall, by a like notification, direct the exclusion from that Schedule of any scheduled bank the aggregate value of whose paid-up capital and reserves at any time becomes less than three lakhs of rupees, or which goes into liquidation or otherwise ceases to carry on banking business.

Agreement with the Imperial Bank.

43. The Bank shall enter into an agreement with the Imperial Bank of India which shall be subject to the approval of the Governor General in Council, and shall be expressed to come into force on the date on which this Chapter comes into force and to remain in force for twenty-five years, and shall further contain the provisions set forth in the Third Schedule.

CHAPTER IV.

GENERAL PROVISIONS.

Allocation of surplus.

44. After making provision for bad and doubtful debts, depreciation in assets, contributions to staff and superannuation funds, and such other contingencies as are usually provided for by bankers, and after payment out of the net annual profits of a cumulative dividend at such rate not exceeding five per cent. per annum on the share capital as the Governor General in Council may fix at the time of the issue of shares, the surplus shall be allocated as follows:—

(*a*) one-half to a Reserve Fund, until such Reserve Fund is equal to one-half of the share capital, and the remaining one-half to the Governor General in Council;

(*b*) thereafter, until the Reserve Fund is equal to the share capital, one-tenth to the Reserve Fund, and the balance to the Governor General in Council; and

(c) when and for so long as the Reserve Fund is not less than the share capital, a portion to an additional dividend to the shareholders calculated on the scale set forth in the Fourth Schedule, and the balance to the Governor General in Council:

Provided that, so long as the Reserve Fund is less than the share capital, not less than fifty lakhs of rupees of the surplus, or the whole of the surplus if less than that amount, shall be allocated to the Reserve Fund.

Publication of bank rate.

45. The Bank shall make public from time to time the minimum rate at which it is prepared to buy or re-discount bills of exchange or other commercial paper eligible for purchase under this Act.

Auditors.

46. (*1*) Not less than two auditors shall be elected and their remuneration fixed at the annual general meeting. The auditors may be shareholders, but no Director or other officer of the Bank shall be eligible during his continuance in office. Any auditor shall be eligible for re-election on quitting office.

(*2*) The first auditors of the Bank may be appointed by the Central Board before the first annual general meeting and, if so appointed, shall hold office only until that meeting. All auditors elected under this section shall severally be, and continue to act as, auditors until the first annual general meeting after their respective elections:

Provided that any casual vacancy in the office of any auditor elected under this section may be filled by the Central Board.

Appointment of special auditors by Government.

47. Without prejudice to anything contained in section 46, the Governor General in Council may at any time appoint such auditors as he thinks fit to examine and report upon the accounts of the Bank.

Powers and duties of auditors.

48. (*1*) Every auditor shall be supplied with a copy of the annual balance sheet, and it shall be his duty to examine the same, together with the accounts and vouchers relating thereto; and every auditor shall have a list delivered to him of all books kept by the Bank, and shall at all reasonable times have access to the books, accounts and other documents of the Bank, and may, at the expense of the Bank if appointed by it or at the expense of the Governor General in Council if appointed by him, employ accountants or other persons to assit him in investigating such accounts, and may, in relation to such accounts, examine any Director or officer of the Bank.

(*2*) The auditors shall make a report to the shareholders or to the Governor General in Council, as the case may be, upon the annual balance-

sheet and accounts, and in every such report they shall state whether, in their opinion, the balance-sheet is a full and fair balance-sheet containing all necessary particulars and properly drawn up so as to exhibit a true and correct view of the state of the Bank's affairs, and, in case they have called for any explanation or information from the Central Board, whether it has been given and whether it is satisfactory. Any such report made to the share-holders shall be read, together with the report of the Central Board, at the annual general meeting.

Returns.

49. (*1*) The Bank shall prepare and transmit to the Governor General in Council a weekly account of the Issue Department and of the Banking Department in the form set out in the Fifth Schedule or in such other form as the Governor General in Council may, by notification in the Gazette of India, prescribe. The Governor General in Council shall cause these accounts to be published weekly in the Gazette of India.

(*2*) The Bank shall also, within two months from the date on which the annual accounts of the Bank are closed, transmit to the Governor General in Council a Copy of the annual accounts signed by the Governor, the Deputy Governors and the Chief Accounting Officer of the Bank, and certified by the auditors, and the Governor General in Council shall cause such accounts to be published in the Gazette of India.

(*3*) The Bank shall also, within two months from the date on which the annual accounts of the Bank are closed, transmit to the Governor General in Council a statement showing the name, address and occupation of, and the number of shares held by, each shareholder of the Bank.

Power to require declaration as to ownership of registered shares.

50. (*1*) The Local Board of any area may at any time require any shareholder who is registered on the Register for that area to furnish to the Local Board within a specified time, not being less than thirty days, a declaration, in such form as the Central Board may by regulations prescribe, giving particulars of all shares on the said Register of which he is the owner.

(*2*) If it appears from such declaration that any shareholder is not the owner of any shares which are registered in his name, the Local Board may amend the Register accordingly.

(*3*) If any person required to make a declaration under sub-section (*1*) fails to make such declaration within the specified time, the Local Board may make an entry against his name in the Register recording such failure and directing that he shall have no right to vote, either under section 9 or section 14, by reason of the shares registered in his name on that Register.

(*4*) Whoever makes a false statement in any declaration furnished by him under sub-section (*1*) shall be deemed to have committed the offence of giving false evidence defined in section 191 of the Indian Penal Code, and shall be punishable under the second paragraph of section 192 of that Code.

Liquidation of the Bank.

51. (*1*) Nothing in the Indian Companies Act, 1913, shall apply to the Bank, and the Bank shall not be placed in voluntary or compulsory liquidation save with the sanction of the Governor General in Council and in such manner as he may direct.

(*2*) In such event the Reserve Fund and surplus assets, if any, of the Bank shall be divided between the Governor General in Council and the shareholders in the proportion of seventy-five per cent. and twenty-five per cent., respectively.

Power of the Central Board to make regulations.

52. (*1*) The Central Board may, with the previous sanction of the Governor General in Council, make regulations consistent with this Act to provide for all matters for which provision is necessary or convenient for the purpose of giving effect to the provisions of this Act.

(*2*) In particular and without prejudice to the generality of the foregoing provision, such regulations may provide for all or any of the following matters namely :—

(*a*) the holding and conduct of elections under this Act, including, if the Central Board thinks fit, provisions for the holding of any elections according to the principle of proportional representation by means of the single transferable vote ;

(*b*) for the final decision of doubts or disputes regarding the qualifications of candidates for election or regarding the validity of elections ;

(*c*) the maintenance of the share register, the manner in which and the conditions subject to which shares may be held and transferred, and, generally, all matters relating to the rights and duties of shareholders ;

(*d*) the manner in which general meetings shall be convened, the procedure to be followed thereat and the manner in which votes may be exercised ;

(*e*) the manner in which notices may be served on behalf of the Bank upon shareholders or other persons ;

(*f*) the manner in which the business of the Central Board shall be transacted, and the procedure to be followed at meetings thereof;

(*g*) the conduct of business of Local Boards and the delegation to such Boards of powers and functions;

(*h*) the delegation of powers and functions of the Central Board to the Governor, or to Deputy Governors, Directors or officers of the Bank;

(*i*) the formation of Committees of the Central Board, the delegation of powers and functions of the Central Board to such Committees, and the conduct of business in such Committees;

(*j*) the constitution and management of staff and superannuation funds for the officers and servants of the Bank;

(*k*) the manner and form in which contracts binding on the Bank may be executed;

(*l*) the provision of an official seal of the Bank and the manner and effect of its use;

(*m*) the manner and form in which the balance sheet of the Bank shall be drawn up, and in which the accounts shall be maintained:

(*n*) the circumstances in which, and the conditions and limitations subject to which, the value of any lost, stolen, mutilated or imperfect currency note of the Government of India or bank note may be refunded; and

(*o*) generally, for the efficient conduct of the business of the Bank.

Amendment of Act III of 1906.

53. In the Indian Coinage Act, 1906, for section 11 the following section shall be substituted, namely:—

Demonetisation of sovereign and half-sovereign.

"11. Gold coins, coined at His Majesty's Royal Mint in England or at any mint established in pursuance of a proclamation of His Majesty as a branch of His Majesty's Royal Mint, shall not be legal tender in British India in payment or on account, but such coins shall be received by the Reserve Bank of India at its offices and agencies in India at the bullion value of such coins calculated at the rate of 8·47512 grains troy of fine gold per rupee."

Repeals.

54. The Indian Paper Currency Act, 1923, the Indian Paper Currency (Amendment) Act, 1923, the Indian Paper Currency (Amendment) Act, 1925, and the Currency Act, 1927, are hereby repealed.

THE FIRST SCHEDULE.

[*See section 4.*]

AREAS SERVED BY THE VARIOUS SHARE REGISTERS.

I. The WESTERN AREA, served by the BOMBAY Register, shall consist of—

the Bombay Presidency including Sind, the Central Provinces, Berar, Hyderabad, Baroda, Khairpur, the Western India States, the Central India States (including Makrai but excluding Rewah and other States of Bundelkhand and Baghelkhand), the Gujerat States, Kolhapur and the Deccan States.

II. The EASTERN AREA, served by the CALCUTTA Register, shall consist of—

the Bengal Presidency, Bihar and Orissa, Assam, Sikkim, Manipur, Cooch-Behar, Tripura, the Eastern States, Rewah and other States of Bundelkhand and Baghelkhand, and the Khasi States.

III. The NORTHERN AREA, served by the DELHI Register, shall consist of—

the United Provinces, Delhi, the Punjab, the North-West Frontier Province, Ajmer-Merwara, Baluchistan, Kashmir, the Punjab States excluding Khairpur, the Simla Hill States, Dujana, Pataudi, Kalsia, Rampur, Tehri-Garhwal, Benares, the Rajputana States including Palanpur and Danta, Gwalior, Khaniadhana, Kalat, Las Bela, Hunza, Nagir, Amb, Chitral, Dir, Phulera and Swat.

IV. The SOUTHERN AREA, served by the MADRAS Register, shall consist of—

the Madras Presidency, Coorg, Mysore and the Madras States.

V. The BURMA AREA, served by the RANGOON Register, shall consist of—

Burma, the Andaman and Nicobar Islands, Bawlake, Kantarawadi and Kyebogyi.

THE SECOND SCHEDULE.

[*See section 43 and section 2(g).*]

SCHEDULED BANKS.

Ajodhia Bank, Fyzabad.
Allahabad Bank.
American Express Company Incorporated.
Banco Nacional Ultramarino.
Bangalore Bank.
Bank of Baroda.

Bank of Behar.
Bank of Chettinad, Madras.
Bank of Hindustan, Madras.
Bank of India, Bombay.
Bank of Indore.
Bank of Mysore.
Bank of Taiwan.
Bank of Upper Burma.
Bari Doab Bank, Lahore.
Benares Bank.
Bhowanipore Banking Corporation, Calcutta.
Bhagwan Das & Co., Dehra Dun.
Byopar Sahayak Bank, Meerut.
Calicut Bank, Calicut.
Canara Bank.
Canara Banking Corporation, Udipi (S. Kanara).
Central Bank of India.
Chartered Bank of India, Australia and China.
Chota Nagpur Banking Association.
Coimbatore Town Bank.
Comptoir National d'Escompte de Paris.
Eastern Bank.
Frontier Bank, Dera Ismail Khan.
Grindlay and Company.
Hongkong and Shanghai Banking Corporation
Imperial Bank of India.
Imperial Bank of Persia.
Indian Bank, Madras
Industrial Bank of Western India, Ahmedabad.
Jalpaiguri Banking and Trading Corporation.
Karnani Industrial Bank.
Kumbakonam Bank, Kumbakonam.
Lloyds Bank.
Mahaluxmi Bank, Chittagong.
Mercantile Bank of India.
Mitsui Bank, Bombay.
Muffassil Bank, Gorakhpur.
Mysore Industrial Bank, Bangalore.
Nadar Bank, Tuticorin.
National Bank of India.
National City Bank of New York.
Nederlandsche Indische Handels-bank.
Nederlandsche Handel-Maatschappij.
Nedungadi Bank, Calicut.
Oudh Commercial Bank.
Pangal Nayak Bank, Udipi.
P. and O. Banking Corporation.
Punjab and Kashmir Bank, Rawalpindi.
Punjab and Sind Bank, Amritsar.
Punjab Co-operative Bank, Amritsar.
Punjab National Bank, Lahore.
Punjab Zamindars' Bank, Lyallpur.
Quilon Bank, Travancore.
Raikut Industrial Bank, Jalpaiguri.
Simla Banking and Industrial Company.
South India Bank, Tinnevelly.
State Aided Bank of Travancore, Alleppey,
Thomas Cook & Sons.
Travancore Commercial Bank, Kottayam.
Travancore National Bank, Tiruvalla.
Union Bank of India, Bombay.
U. Rai Gyaw Thoo and Co, Akyab.
Yokohama Specie Bank.

THE THIRD SCHEDULE.

(See section 43.)

Provisions to be contained in the agreement between the Reseve Bank of India and the Imperial Bank of India.

1. The Imperial Bank of India shall be the sole agent of the Reserve Bank of India at all places in British India where, at the commencement of the Reserve Bank of India Act, 1933, there is a branch of the Imperial Bank of India and no branch of the Banking Department of the Reserve Bank of India.

2. In consideration of the performance by the Imperial Bank of India on behalf of the Reserve Bank of India of the functions which the Imperial Bank of India was performing on behalf of the Governor General in Council at the places referred to in clause I before the coming into force of the Reserve Bank of India Act, 1933, the Reserve Bank of India shall pay to the Imperial Bank of India a commission calculated on the total of the receipts and disbursements dealt with annually on account of Government by the Imperial Bank of India on behalf of the Reserve Bank of India. Such commission shall be one-sixteenth of one per cent. on the first 250 crores of such total and one-thirty-second of one per cent. on the remainder.

3. Subject to the condition that the Imperial Bank of India shall keep open branches not less in number than those existing at the time of the coming into force of the Reser e Bank of India Act, 1933, the Reserve Bank of India shall allow the following balances to the Imperial Bank of India at the interest rates hereinafter specified, namely :—

(*a*) during the first five years from that time—3 crores free of interest;

(*b*) during the next five years—2 crores free of interest and, at the option of the Imperial Bank of India, an amount not exceeding 1 crore at 2 per cent. per annum ;

(*c*) during the next five years—1 crore free of interest and, at the option of the Imperial Bank of India, an amount not exceeding 2 crores at 2 per cent. per annum ; and

(*d*) during the next five years—at the option of the Imperial Bank of India, an amount not exceeding 3 crores at 2 per cent. per annum.

4. The Imperial Bank of India shall not without the approval of the Reserve Bank of India open any branch in substitution for a branch existing at the time this agreement comes into force.

THE FOURTH SCHEDULE.

(*See section 44.*)

Scale of additional dividend payable to shareholders.

A. If the maximum rate of dividend fixed under secton 44 is five per centum and so long as the share capital of the Bank is five crores of rupees—

(1) if the surplus does not exceed four crores of rupees—*Nil*;

(2) if the surplus exceeds four crores of rupees—

(*a*) out of such excess up to the first one and a half crores of rupees—a fraction equal to one-sixtieth ;

(*b*) out of each successive additional excess up to one and a half crores of rupees—one-half of the fraction payable out of the next previous one and a half crores of excess ;

Provided that the additional dividend shall be a multiple of one-eighth of one per cent on the share capital, the amount of the surplus allocated thereto being rounded up or down to the nearest one-eighth of one per cent. on the share capital.

B. If the maximum rate of dividend fixed under section 44 is below five per centum, the said fraction of one-sixtieth shall be increased in the ratio of the difference between six and the fixed rate to unity.

C. When the original share capital of the Bank has been increased or reduced, the said fraction of one-sixtieth shall be increased or diminished in proportion to the increase or reduction of the share capital.

THE FIFTH SCHEDULE.

(See section 49.)

RESERVE BANK OF INDIA.

An Account pursuant to the Reserve Bank of India Act, 1933, for the week ending on the day of

ISSUE DEPARTMENT.

Liabilities.	Rs.	*Assets.*	Rs.
Bank Notes held in the Banking Department		A. Gold coin and bullion—	
Bank Notes in circulation ...		(*a*) held in India ...	
Total Bank Notes issued ...		(*b*) held outside India ...	
Government of India Notes in circulation		Securities of sterling standard countries	
		Total of A ...	
		B. Rupee coin ...	
		Government of India rupee securities	
		Internal bills of exchange and other commercial paper ...	
Total Liabilities ...		Total Assets ...	

Ratio of total of A to liabilities, per cent.

Dated the day of 19

BANKING DEPARTMENT.

Liabilities.	Rs.	*Assets.*	Rs.
Capital paid up		Notes	
Reserve Fund		Rupee coin	
Deposits—		Subsidiary coin	
(*a*) Government ...		Bills discounted—	
(*b*) Banks... ...		(*a*) Internal ...	
(*c*) Others ...		(*b*) External ...	
Bills payable		(*c*) Government of India Treasury Bills ...	
Other liabilities		Balances held abroad ...	
		Loans and advances to the Government	
		Other loans and advances ...	
		Investments	
		Other assets	

Dated the day of 19

STATEMENT OF OBJECTS AND REASONS.

The object of this Bill is to set up a Reserve Bank for India. The Federal Structure Sub-Committee of the first Round Table Conference recommended that "with a view to ensuring confidence in the management of Indian credit and currency.....efforts should be made to establish on sure foundations and free from any political influence, as early as may be found possible, a Reserve Bank, which will be entrusted with the management of the currency and exchange". The Financial Safeguards Committee of the third Round Table Conference recommended "that steps should be taken to introduce into the Indian Legislature a Reserve Bank Bill conceived on the above lines as soon as possible." In the report of that Committee it was also placed on record that "the Secretary of State undertook that representative Indian opinion would be consulted in the preparation of proposals for the establishment of the Reserve Bank including those relating to the reserves."

2. A representative Committee was set up in order to give effect to that undertaking and a copy of its report is attached as an annexure. The present Bill is drafted in accordance with the recommendations of that Committee.

SIMLA,

The 4th September, 1933.

GEORGE SCHUSTER.

NOTES ON CLAUSES.

[In these notes "Report" means the report of the Committee on Indian Reserve Bank Legislation, 1933, and "1928 Bill" means the Gold Standard and Reserve Bank of India Bill, 1928.]

Preamble.—The wording is intended to give effect to paragraph 19 of the Report.

Clause 1 reproduces clause 1 of the 1928 Bill with the following alterations :—

(*a*) In sub-clause (*3*) the date and the proviso giving dates for postponement have been omitted.

(*b*) Sub-clause (*4*) has been drafted in pursuance of the Committee's recommendation relating to this sub-clause, contained in Appendix I to the Report. Their intention was to provide a statutory assurance to the Bank when constituted that the provisions of Chapter III, relating to its central banking functions, would remain in operation for a period of not less than twenty-five years. It is recognised, however, that the sub-clause is inoperative as it cannot bind the

Legislature in the future ; and it will be for consideration at a later stage whether this assurance would not be more suitably expressed in clause 50, in the form of a limitation on the power of the Governor General in Council to grant sanction to the liquidation of the Bank.

Clause 2 follows clause 2 of the 1928 Bill. Some of the definitions have been omitted as unnecessary. The only alteration of substance is in sub-clause (*d*), where the definition of a gold standard country has been replaced by that of a sterling standard country, *vide* Appendix 1 of the Report [note on clause 2 (*g*) of the 1928 Bill].

Clause 4 follows clause 4 of the 1928 Bill with alterations made in accordance with paragraphs 3, 4 and 14 of the Report. In sub-clause (*5*) the distribution is as indicated in paragraphs 6 and 7 of the Report and the Rangoon register has been retained, *vide* paragraph 2 of the Report. Sub-clause (*6*) has been drafted with a view to giving effect to the intention of the Report and will require special consideration in the Joint Committee.

Clause 6 has been altered so as to make the establishment of a London branch optional, *vide* paragraph 8 of the Report.

Clauses 8 to 13 reproduce the proposals for the constitution of the Central Board, the method of election, the qualifications and disqualifications of candidates, the method of filling casual vacancies, and the provision for Local Boards, indicated in paragraphs 5 to 13 of the Report under the general head "The Board of the Bank". The opportunity has also been taken to rearrange clauses 8 to 13 of the 1928 Bill so as to make the arrangement clearer.

Clause 9 is new : it embodies the recommendations regarding Local Boards in paragraph 9 of the Report, and replaces the scheme of electoral colleges contained in clause 10 of the 1928 Bill.

Clause 10 embodies the recommendations in paragraphs 10 and 11 of the Report. It follows clause 8 of the 1928 Bill *mutatis mutandis*.

Clause 11 is drafted to give effect in a practical form to the intentions of the comments in Appendix 1 of the Report on clause 11 (*1*) of the 1928 Bill.

Clause 12.—Sub-clause (2) has been drafted so as to give effect to the recommendation in the last sentence of paragraph 7 of the Report.

The rule-making powers contained in clause 13 of the 1928 Bill have been given to the Central Board and transferred to clause 52, where they appear as clauses (*a*) and (*b*) of sub-clause (*2*) (*vide* notes in Appendix I of the Report on that clause).

Clause 13.—Sub-clause (2) is new, and fills what appears to have been an omission from the 1928 Bill.

Clause 15 reproduces clause 16 of the 1928 Bill with the necessary modifications to give effect to the recommendations of paragraph 12 of the Report, and the different method for the election of Directors now proposed.

Sub-clause (*4*) represents an attempt to provide "suitable arrangements.....for retirement by rotation" as recommended in paragraph 12 of the Report.

Clause 17 reproduces clause 17 of the 1928 Bill with the inclusion of the points made in Appendix I of the Report.

Clause 18 reproduces clause 18 of the 1928 Bill with the addition of provision designed to meet the recommendation in the last sentence of paragraph 18 of the Report.

Clause 30 reproduces clause 43 of the 1928 Bill ; it is placed here so as to make the arrangement clearer.

Clause 33 reproduces clause 31 of the 1928 Bill with the following alterations :—

(*a*) Sub clause (2) incorporates the provision regarding gold suggested in paragraph 24 of the Report.

(*b*) Sub-clause (3)—Holding of Government of India rupee securities.—The provisions of the 1928 Bill have been followed without alteration for the present, but the point raised in paragraph 22 of the Report is reserved for consideration in Joint Committee.

(*c*) Sub-clause (*4*).—For the time being gold has been valued on the principle recommended in paragraph 25 of the Report, the question of the allocation of the profits, if any, on realization or revaluation being left for later consideration. This will properly be dealt with in a separate agreement between Government and the Reserve Bank. This point is reserved for consideration at the Committee stage.

(*d*) Sub-clause (*6*) (c).—Gold securities have been replaced by sterling securities as recommended in paragraph 23 of the report

Clause 34 reproduces clause 32 of the 1928 Bill with the modifications regarding the Rupee Redemption Fund indicated in paragraph 21 of the Report.

Clause 36 is new, replacing clauses 34 and 35 of the 1928 Bill. It embodies the recommendations of the Committee in paragraph 21 regarding the transfer of rupee coin between Government and the Bank.

Clause 37 reproduces clause 41 of the 1928 Bill. It has been transferred here for the purpose recommended in paragraph 26 of the Report.

Clauses 40 and 41 contain the new provisions regarding the purchase and sale of sterling exchange, *vide* paragraphs 19 and 20 of the Report. Clause 40 of course takes the place of clauses 38 and 39 of the 1928 Bill providing for the obligation to sell gold or gold exchange. Clause 40 of the 1928 Bill has been omitted as it would be inoperative.

Clause 42 reproduces clause 44 of the 1928 Bill without alteration, the principle of this clause having been approved in paragraph 28 of the Report. The detailed application of this principle, however, must receive careful consideration as recommended in paragraph 28 and the Committee stage will offer a convenient opportunity for this.

Clause 43 reproduces the old clause 45, *vide* paragraphs 29 and 31 of the Report. The Second Schedule giving the arrangements to be made with the Imperial Bank has also been left unaltered for the present but will be another matter for consideration in Joint Committee.

Clause 44 reproduces clause 46 of the old Bill but the Fourth Schedule (old Schedule Three) has been modified so as to provide for a maximum 6 per cent. dividend—*vide* paragraph 27 of the Report; *vide* also note on the Fourth Schedule.

Clause 50.—This represents a tentative working out of the suggestion contained in the note on clause 15 (2) in Appendix I to the Report. The subject presents serious difficulties which will have to be considered at a later stage.

Clause 52.—Certain modifications and additions have been made in the regulation-making powers (*vide* note on clause 13 of the 1928 Bill *ante*).

The First Schedule.—This has been framed in accordance with the recommendations in paragraph 7 of the Report. Appendix II of the Report has been amplified, in accordance with current distribution and nomenclature.

The Second Schedule.—The First Schedule of the 1928 Bill has been brought up to date in accordance with the latest information available. It may, however, be altered in the light of later information before the Bill comes up for final consideration.

The Fourth Schedule (*vide* note on clause 44) provides for a maximum dividend of six per cent. to be reached by stages diminishing by fifty per cent. successively with a minimum rise of ⅛ per cent. Thus, if the fixed minimum

dividend is five per cent., it will be raised to 5½ per cent. if the distributable surplus rises to 5½ crores, to 5¾ per cent. if it rises to 7 crores, and so on. If the fixed minimum is 4 per cent., the stages will be 5 per cent., 5½ per cent., and so on. This follows the provisions of the Third Schedule of the 1928 Bill, except for the fact that the 1928 Schedule provided for a maximum dividend of seven per cent.

The Fifth Schedule reproduces the Forth Schedule of the 1928 Bill with the alterations necessitated by the modifications in the body of the Bill.